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SECTOR IN-DEPTH
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Housing and Housing Finance: US

Housing in flux as high rates, prices hit demand; owners with low rates stay put

Summary

» **Rising rates and still-high prices**. Massive price appreciation and mortgage interest rates that doubled from lows are pushing prospective buyers out of the market, cutting into home demand. This is hurting homebuilders and mortgage lenders. Our macroeconomic board is forecasting a mild recession in the second half of 2023 and an associated increase in unemployment that will put further stress on home sales and prices. On a national basis, we expect existing home prices to decline about 4% both this year and next, with declines from peak values of 15%-25% or more possible in some areas.

» **Home equity offers safety net for mortgage credit quality**. While it scared off many potential buyers, substantial price appreciation is beneficial to mortgage lenders and insurers, since sufficient equity should, in most circumstances, be a buffer against falling prices, and mitigate losses in the event of a rise in delinquencies. The price appreciation also increases collateral quality for residential mortgage-backed securities (RMBS) and Housing Finance Agencies (HFAs), though a marked slowdown in mortgage prepayments is a credit negative for RMBS performance. Continued strong employment is another supporting factor.

» **Low rates keep potential sellers on sidelines**. Homeowners that locked in low mortgage rates are reluctant to give up those loans, resulting in few existing homes hitting the market and, on those that do, sellers who are unwilling to cut prices. This is hurting brokerages and pushing some real estate agents out of the industry. By contrast, home improvement retailers — although experiencing some pullback after years of outsized growth — continue to benefit as homeowners invest and remote or hybrid work adds to wear and tear on aging housing stock.

» **Multifamily property fundamentals have weakened, but CMBS delinquency remains low**. Despite recent weakening, fundamentals for multifamily collateral underlying commercial mortgage-backed securities (CMBS) remain among the strongest in the commercial real estate sector. Multifamily REITs remain resilient with lower leverage and ample liquidity, despite the challenges of inflation, higher rates and slower rent growth. The portfolios of HFA multifamily programs are performing very well because of strong demand for affordable housing.

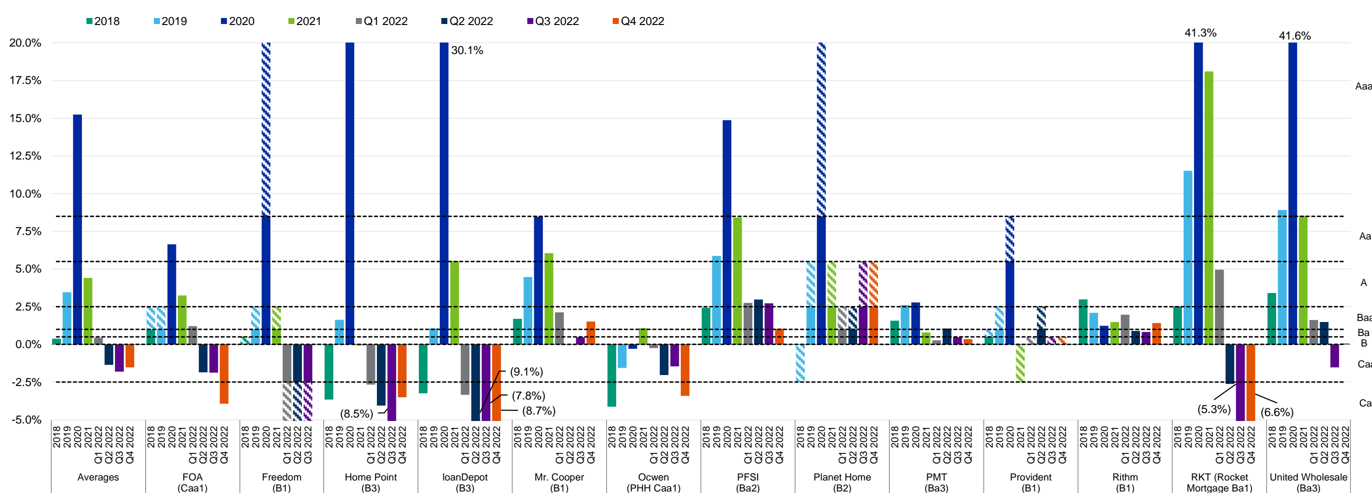
Click to listen to the webinar, US Housing & Housing Finance: 9 Sectors in 60 Minutes.

Non-Bank Mortgage Companies: Profit likely to improve modestly in second and third quarters, after weak end to 2022

Core profitability at US non-bank mortgage companies was likely weak again in the first quarter, but we believe it should improve modestly in the second and third quarters, before diminishing again in the last few months of the year on homebuying seasonality. The companies' reported profitability was very weak in Q4 2022, driven by a drop in net rate lock volumes, depressed gain-on-sale margins, and still somewhat elevated operating expenses (see Exhibit 1). In addition, companies incurred mortgage servicing right (MSR) fair value declines.

Exhibit 1

Core profitability remains very weak, but will likely improve modestly in 2023 and more in 2024
Core income / average adjusted assets, fiscal year 2018 - Q4 2022



1) Core profitability is equal to pretax profitability excluding MSR FV marks and nonrecurring items and a tax adjustment equal to the effective tax rate for the period for each company divided by average adjusted tangible managed assets. 2) We use the federal statutory tax rate of 21% for Ocwen, PMT, Rithm and for Mr. Cooper's 2019 calculation. 3) For Mr. Cooper's 2018 effective tax rate, we use the predecessor tax rate of 23.8%. 4) The dashed horizontal black lines indicate scoring ranges for this ratio. 5) Freedom, Planet Home and Provident do not disclose historical financial information and, therefore, their metrics are shown as dashed vertical colored bars indicating the range of performance based on Moody's scorecard. For example, if net income were actually 4%, net income/average managed assets would be assessed at A. The range for an A assessment is 2.5% - 5.5%. The chart above would then show dashed bars at 2.5% - 5.5%. Actual results for private companies for the lowest and highest groupings may be outside of the given range.
Source: Moody's Investors Service, Company Filings

Seven of the 12 non-bank mortgage companies we rate reported net losses in Q4, with average net income to average total assets for the rated sector dropping to -2.5%, from 1.3% in Q3. Core profitability, which excludes MSR fair value marks and other non-recurring items, was also very weak at -1.5%, a modest improvement from -1.8% in Q3. Profitability will likely improve modestly in 2023 and more in 2024 — unless the economic forecast worsens materially — as excess origination capacity in the industry continues to decline. Origination volumes will likely continue to be depressed throughout this year, as high interest rates reduce not only refinance originations, but also purchase originations because homes are less affordable and owners with lower mortgage rates are reluctant to sell, meaning fewer homes on the market.

US Banks: Residential mortgage charge-offs remain very low; performance will modestly deteriorate

Residential mortgage delinquencies largely returned to pre-pandemic levels after spiking in the second half of 2020 (see Exhibit 2), when there was a sharp increase of loans in forbearance at the onset of the pandemic. Banks' residential mortgage net charge-offs hovered near zero for several years thanks to solid underwriting, home price appreciation and nominal income growth. Our macroeconomic board is forecasting a mild recession, with unemployment peaking around 5%, which is likely to somewhat increase delinquencies when combined with a modest decline in home prices (see Exhibit 3).

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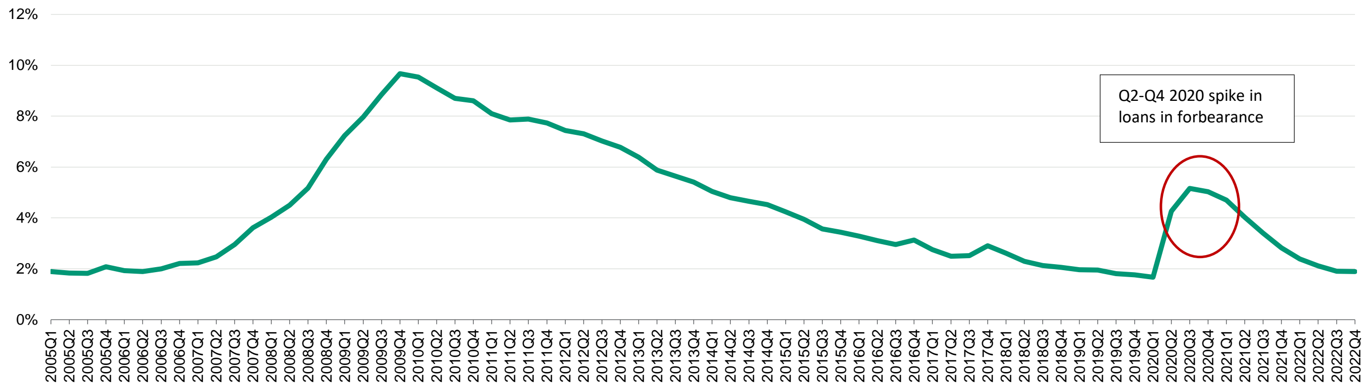
Still, homeowners locked in low rate mortgages and benefited from very high home price appreciation; and lenders have flexible modification programs that will ensure the increase in charge-offs will be far smaller than that following the 2007-08 financial crisis.

Exhibit 2

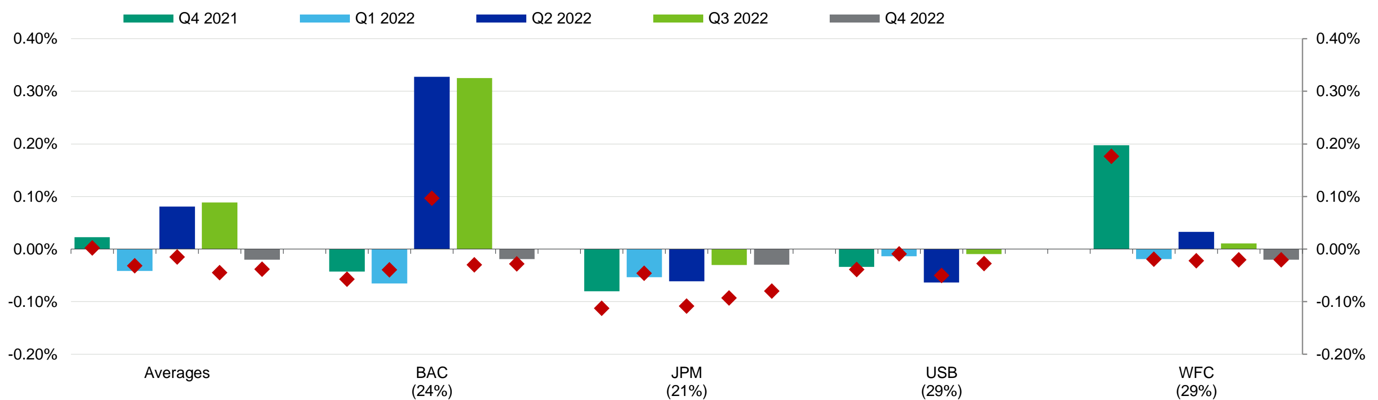
Mortgage delinquencies continue to decline, driven by job market, home price appreciation; as economy slows, delinquencies will rise
Loans 90 or more days delinquent or in foreclosure as a % of outstanding loan amount



Source: Mortgage Bankers Association, Moody's Investors Service

Exhibit 3

Residential mortgage charge-offs remain very low; performance will deteriorate, but only modestly, even as home prices decline
Residential mortgage charge-offs % (diamonds) and change versus 2019 (bars) for selected large US residential mortgage lenders



1) The percentages in the X-axis represent residential mortgage loans as a proportion of total loans as of Q3 2022. 2) The bars represent the change compared with the same period in 2019. 3) The Q4 2022 average excludes USB. 4) BAC = Bank of America Corporation, JPM = JPMorgan Chase & Co., USB = U.S. Bancorp, WFC = Wells Fargo & Company.
Source: Moody's Investors Service, Company Filings

Recent US banking system stress has mixed implications for housing. The significant roles of Fannie Mae, Freddie Mac and the US government in the mortgage market limits the importance of banks in holding, originating and servicing mortgages, but the developments will likely be negative for mortgage credit availability and costs — especially for jumbo loans.

RMBS: Loan, borrower strength supports performance; fewer prepayments pose risk

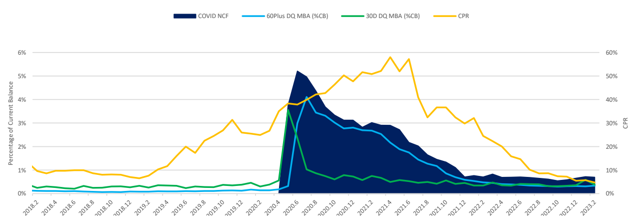
The performance of residential mortgage-backed securities (RMBS) will remain strong, despite higher interest rates, reflecting transactions' low exposure to rate fluctuations and strong collateral quality. Furthermore, borrowers' overall financial health will extend support for RMBS performance.

Despite worsening economic and financial conditions, RMBS delinquencies and defaults have stayed stable (see Exhibits 4 & 5). Most loans underlying existing RMBS are fixed rate, supporting borrowers' ability to repay. Among RMBS deals completed after 2009, prime jumbo and government-sponsored enterprise (GSE) collateral was overwhelmingly fixed rate at origination. Over the years, servicers also modified a large proportion of the collateral underlying older RMBS to fixed rate. Pool performance also benefits from the tighter underwriting standards after 2008 from both regulators and lenders, elevating the credit quality of subsequent mortgage originations. Additionally, gains in borrowers' equity, driven by jumps in home prices since the pandemic's onset, and a healthy labor market are keeping delinquencies low.

Exhibit 4

Prime jumbo RMBS delinquencies were stable over the past year

Performance metrics for prime jumbo 2.0 transactions

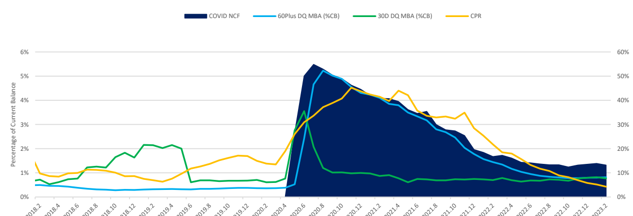


COVID NCF = loans that became non-cash-flowing, including as a result of payment relief, after the COVID-19 pandemic's onset.[1] DQ MBA = delinquencies as calculated under the methodology used by the Mortgage Bankers Association. CPR = constant prepayment rate.
Source: Moody's Investors Service and Moody's Analytics Structured Finance Data Portal

Exhibit 5

GSE credit risk transfer (CRT) delinquencies were also stable recently

Performance metrics for GSE CRT transactions



Source: Moody's Investors Service and Moody's Analytics Structured Finance Data Portal

Still, rising unemployment through the end of this year poses some credit risk to RMBS. If a recession takes hold this year, we expect unemployment will rise to 5%, eroding some borrowers' ability to pay household debts, including mortgages.

Also, rising rates are diminishing refinancing originations, and the marked slowdown in mortgage prepayments is a credit negative for RMBS performance. Elevated rates led to a contraction in the number of borrowers who could potentially benefit from refinancing their mortgage, cutting mortgage prepayments and raising the probability of increased losses. For RMBS notes, lower prepayments will translate into slower buildup of credit enhancement. Such slowdowns are especially credit negative for senior notes from recent vintage transactions, which would otherwise benefit the most from prepayments.

Mortgage Insurers: Strong capital adequacy offsets higher economic risks

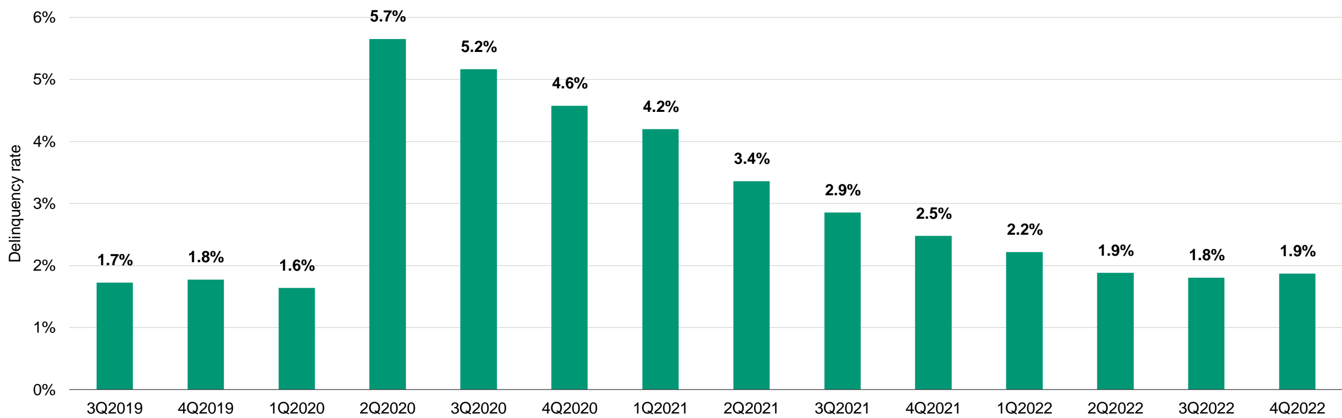
For the US mortgage insurance sector we expect good profitability as high persistency rates and investment income help offset the potential for more defaults in the months ahead. This meshes with our expectation that the macroeconomic downturn in the US will be relatively mild and have only a moderate effect on mortgage credit. Although the sharp rise in interest rates reduced housing affordability, which will likely cause a decline in home prices, unemployment remains low and the credit quality of insured portfolios is high. Capital adequacy is solid, supported by significant use of reinsurance.

Last year, US mortgage insurers' profitability was strong, with full-year pretax operating income of about $6.1 billion. These results benefited from high cure rates on delinquent mortgage loans, which resulted in loss reserve releases over the course of the year that boosted underwriting results. At the end of last year, the sector's overall delinquency rate was about 1.9%, down from the pandemic-related spike up to 5.7% during Q2 2020, and very close to pre-pandemic levels (see Exhibit 6). We expect the delinquency rate to tick higher as the economy slows, but this should affect overall sector profitability only moderately. Given the embedded house price appreciation from the past several years, roughly 80% to 90% of mortgages within insured portfolios have mark-to-market LTV ratios of 85% or lower. As a result, there is sufficient homeowners' equity to cushion the effect of falling home prices, which should mitigate losses in the event mortgage delinquency rates rise.

Exhibit 6

Mortgage insurance sector's delinquency rate close to pre-pandemic levels

US mortgage insurance sector aggregate delinquency rate



Source: Company Reports, Moody's Investors Service

At year-end 2022, approximately 80% of sector risk-in-force was concentrated in the 2020-2022 loan vintages, with about 25.7% underwritten last year. We believe loans originated in the H2 2022 are more vulnerable to a pullback in home prices, since these borrowers did not benefit from the strong price appreciation in 2020 and 2021. To guard against higher defaults, mortgage insurers increased prices to mitigate the effects of falling home prices on ultimate incurred losses.

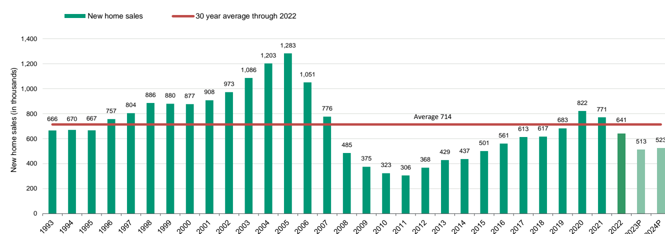
Homebuilding: Reset means broad-based declines, with stabilization next year

Higher interest rates and home prices that remain elevated, despite some declines, will hurt home purchasing activity. We expect declines across multiple indicators in the US single-family housing sector, including single-family housing starts, new home sales, home prices, and homebuilder-specific figures such as closings, revenue, and gross margins throughout this year. New home prices will decline 10% - 15% this year given weaker demand and homebuilders' softening pricing power.

We forecast new home sales will drop 20%, to about 500,000 units, a level comparable to sales during 2015 and 2016 (see Exhibit 7). Homebuilders' quick reaction and adjustment of construction levels to match demand is reflected in materially lower single-family housing starts, which declined 11% last year. This year, we will see a more significant decline of about 18.5% to 800,000 units, which is more in line with the average during the five years preceding the pandemic (see Exhibit 8). Following this reset, in 2024, we expect demand and construction activity to stabilize. Although to a lesser degree, new home prices will weaken further in 2024, dropping 3% - 5%. Lower home prices are likely to lead to modest affordability improvement, a positive for potential homebuyers.

Exhibit 7

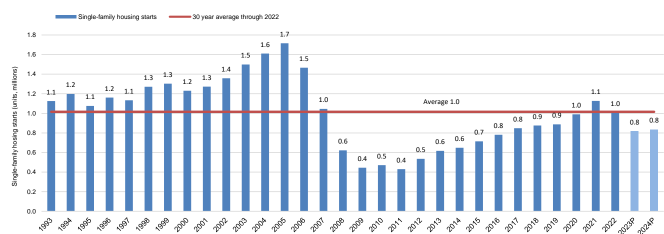
New home sales constrained by affordability



Source: US Census Bureau, Moody's Investors Service Projections (2023-2024)

Exhibit 8

Single-family construction activity to fall below 30-year average

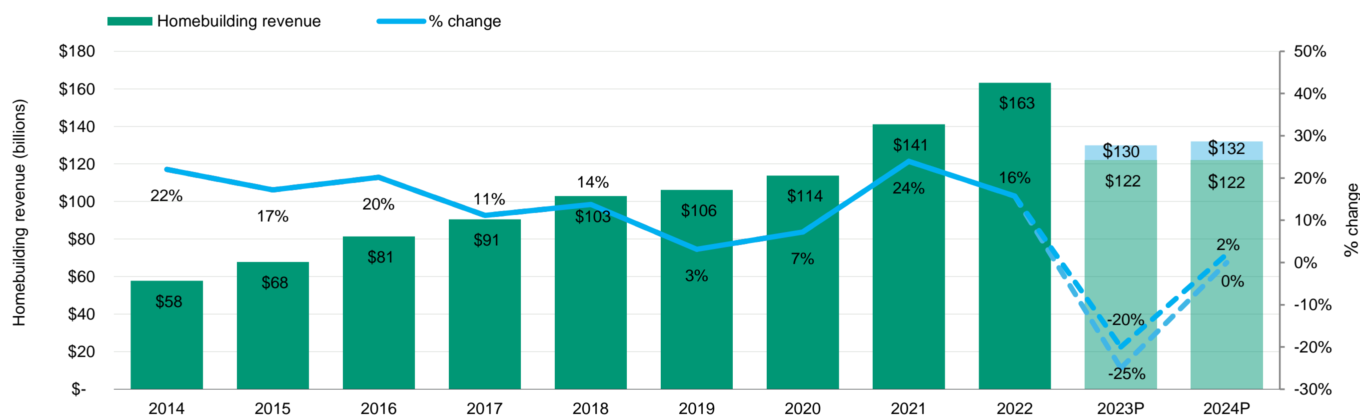


Source: US Census Bureau, Moody's Investors Service Projections (2023-2024)

We project revenue for rated homebuilders will decline 20% - 25% for the full year 2023, following strong growth the last two years (see Exhibit 9). Homebuilding revenue in 2024 should be generally in line with this year, reflecting stabilizing market conditions. Homebuilding gross margins should return to pre-pandemic levels in 2023 in the range of 20% - 21%, given lower new home prices and input costs that remain high. With moderate home price declines and gross margins returning to long-term averages, we expect impairments to be relatively modest and manageable. Unlike during the Global Financial Crisis, we do not foresee homebuilders' debt-to-capitalization rising in the next few years because of: low risk of significant impairments; little need for additional debt and strong cash and cash flow as construction slows; continued net income generation; and anticipation of a disciplined approach to share repurchases. In fact, leverage could improve for many homebuilders, even during weak market conditions, if they maintain conservative financial policies and continue to repay debt.

Exhibit 9

Homebuilding revenue will decline significantly this year, but remain well above the pre-pandemic level; stay about flat for 2024



Aggregate revenue of 21 rated homebuilders

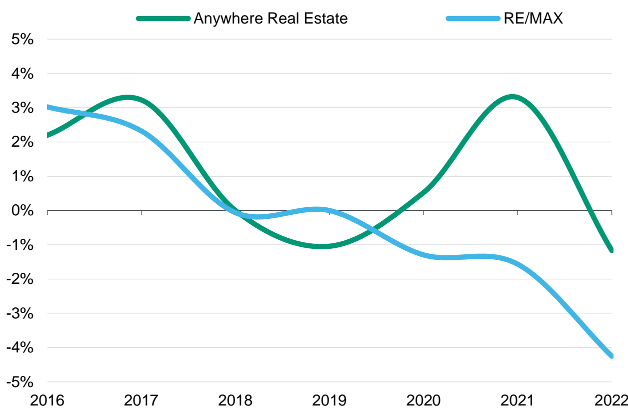
Source: Moody's Financial Metrics, Moody's Projections

Brokers: Fewer existing home sales, but average prices down only modestly this year

We expect existing home sales will be way down in 2023 with the market frozen by higher interest rates, still-high prices and homeowners unwilling to relinquish mortgages financed when rates were half their current level. Prices are likely to remain fairly firm, down only slightly in most markets, with larger corrections in certain important markets like San Francisco and the surrounding area.

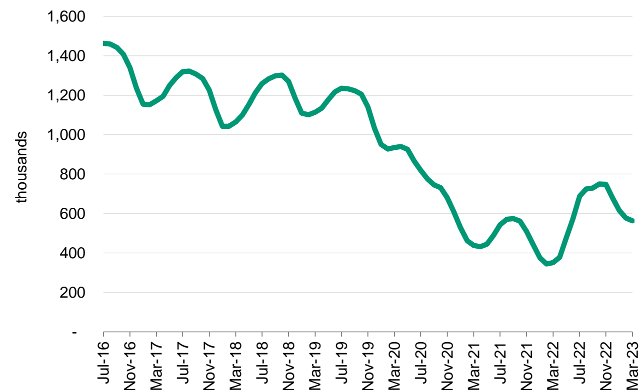
Publicly-traded brokers Anywhere Real Estate Inc. and RE/MAX Holdings Inc. — parent of Anywhere Real Estate Group LLC, (B1 negative) and indirect parent of RE/MAX, LLC (B1 negative), respectively — both report declines in the number of sales agents working, a direct result of the market freeze (see Exhibit 10). The low number of listings is a legacy of the boom that ended before interest rates began to rise last spring, but limited inventory is also supporting average sale price (see Exhibit 11). Over the course of the year though, if the market continues to be frozen, those inventories will build, and prices may come under pressure as forced or motivated sellers confront buyers worried about interest rates and further price declines.

Exhibit 10
Number of working agents in US will remain under pressure...
Fewer existing home sales in 2022 led to fewer agents working



US sales agent growth
Source: Company Filings

Exhibit 11
... while high interest rates, few listings keep transactions down
Limited supply of existing homes available for sale supports average price



North America monthly active for-sale listings
Source: Realtor.com® Economic Research

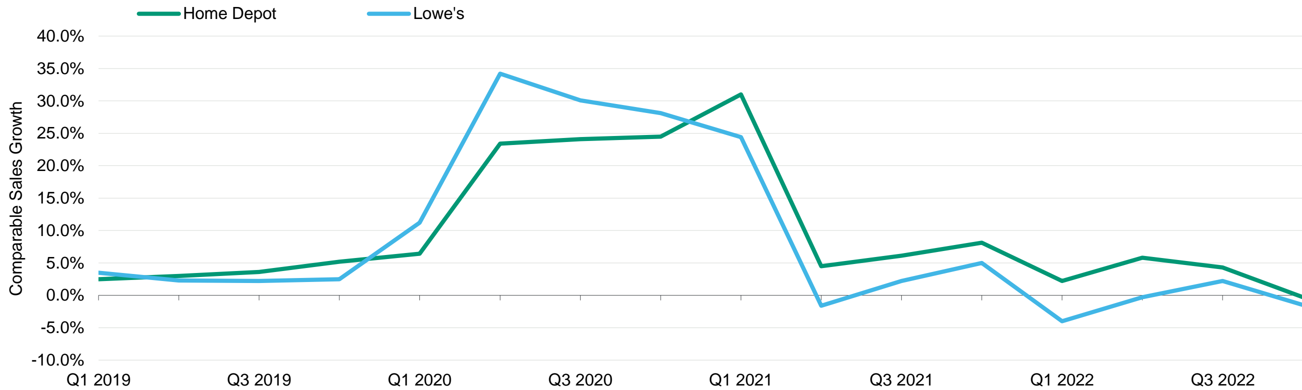
The very large declines in transaction volumes that began during 2022 — down 25% - 30% for Q3 and Q4 last year — likely remained sizable in early 2023 as well. So unless some unexpected boost occurs, full-year 2023 figures are almost sure to end up worse than last year. Despite the poor revenue, earnings and cash flow last year, and the sense that this year will be even worse, the payoff for a broker is still good on a per-transaction basis — although there are far fewer payoffs.

We expect average sales prices will decline much more modestly than the number of transactions, and broker's fees remain aligned with prices. The public brokers continue to report an average total fee around 5% of average sales price, though this rate is slowly falling.

Home Improvement Retailers: Sales to slow after lockdown boom times

The home improvement market is poised to slow modestly in 2023 after its outsized growth since the onset of the pandemic (see Exhibit 12). Home Depot (A2 stable), for example, grew by a compound annual rate of 12.6% from 2019 to 2022. Home improvement remains very fragmented with the largest companies, Home Depot and Lowe's (Baa1 stable), likely to outperform. We estimate a low single digit percentage decline in organic revenue growth for these companies as consumers shift spending to services and the economic picture remains unclear. Homeowners are typically wealthier than the average US consumer and have more disposable income to absorb the current level of high inflation on a relative basis. Also, they are predominantly benefiting from a low fixed-rate mortgage or own their home outright. Nonetheless, sales growth in recent quarters was driven by price, as units decline and price elasticity increases.

Exhibit 12
Home improvement sales normalize after period of unprecedented growth



Source: Moody's Investors Service, Company Filings

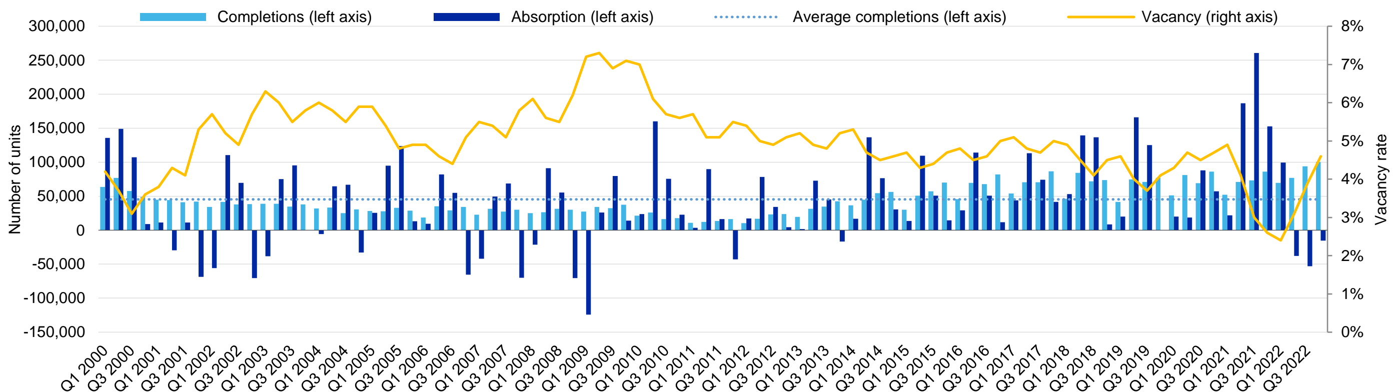
Fundamentals remain favorable for these companies, despite a weaker housing market and rising interest rates. Significant equity appreciation in the last couple years supports investment by homeowners. Remote and hybrid work also resulted in more time spent at home, increasing the need for repairs. Also, the average age of the housing stock in the US continues to rise and is estimated to be over 40 years, supporting home improvement spending. Homeowners who locked in a low interest mortgage are also inclined to remain in their home and retrofit the space rather than sell. Cost increases are abating for home improvement retailers, but rising wages will be a significant offset.

Multifamily REITs: Stable despite higher rates, inflation, slower rent growth

In spite of inflation, higher interest rates and slower rent growth, multifamily REITs remain resilient with lower leverage, ample liquidity and broad access to capital, including via Fannie Mae and Freddie Mac, to navigate the current operating environment.

We expect rent growth to slow from peak year-over-year growth in 2021-22. This deceleration may vary from 4%-9% in new same store rent growth in 2023-24, versus the double-digit percentage growth experienced during the last two years. Rising interest expense and other operating expenses, including real estate taxes and insurance, will erode EBITDA margins, offset by controllable expenses the REITs can reduce. Corporate layoffs could soften rental demand in some urban markets, and may reduce apartment demand. High levels of household formation between 2020 and 2022 supported multifamily rental growth as they provide the tenant base for most rated multifamily REITs, with income-to-rent ratios of 4:1. Economic uncertainty may slow down new household formation, which will affect demand in some markets (see Exhibit 13).

Exhibit 13
Multifamily supply topped historical averages through last year



Source: CBRE Econometric Advisors, Moody's Investors Service

Apartment REITs are trading at a discount to net asset value, making new stock offerings unattractive. These REITs are able to pay off debt or fund growth by selling noncore assets since there is still solid demand from institutional investors for high-quality properties. Property sale cap rates and bond issuance prices remain competitive for investment grade multifamily REITs. All of the rated multifamily REITs were able to reduce leverage in 2021-22 to all-time lows. Multifamily REITs grew through development in the last two years, but we see diminished development pipelines now, mostly related to prudence from the companies as they analyze their markets and determine the best use of capital.

Multifamily Collateral: Property fundamentals weakened in 2022, but CMBS delinquency remains low

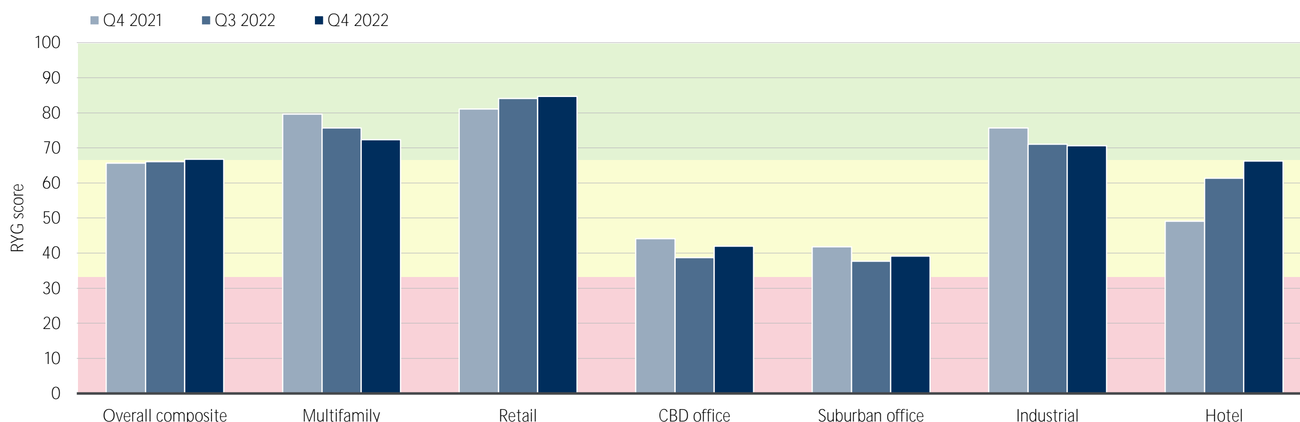
A widespread rise in vacancies from pandemic lows has somewhat weakened fundamentals for multifamily collateral underlying commercial mortgage-backed securities (CMBS) (see Exhibit 14). We track supply and demand across commercial real estate (CRE) sectors, and found that the multifamily vacancy rate increased to 4.6% in Q4 2022 from 3.9% in Q3 2022 and 2.6% a year earlier (see Exhibit 13). For Q4 2022, year-over-year vacancy rates deteriorated in 68 markets and improved only in Madison, Wisconsin. Vacancy growth led overall multifamily fundamentals to weaken for three consecutive quarters.

Despite recent weakening, fundamentals for multifamily collateral underlying CMBS are still among the strongest within the CRE sector. The multifamily supply-demand ratio, which measures projected absorption, improved in Q4 2022, driven by a decrease in upcoming supply.

Exhibit 14

Multifamily market fundamentals weakened in 2022 but remained strong[2]

Red-Yellow-Green scores, by property type



Red = markets already under stress. Yellow = markets on the cusp of imbalance. Green = markets where demand is outpacing the growth in supply, or the ratio is within one percentage point.

Source: Moody's Investors Service, based on data from CBRE Econometric Advisors

CMBS: Multifamily collateral will extend support for CMBS performance

Multifamily remains a leading CRE performer, as demonstrated by strong income growth and low delinquencies (1.22% in March of 2023).[3] This fundamental strength will uphold loan performance and reflects strong tenant demand, including through the pandemic. Diversification is important within CRE pools, so apartment loans should remain a large share of collateral in CMBS and commercial real estate collateralized loan obligation (CRE CLO) pools.

However, multifamily affordability for tenants remains a growing concern, which will increase rent regulation, curtailing properties' cash flow growth. Beyond affordability, carbon-emission regulations are becoming more prevalent, creating costs for compliance and potential fines that will limit cash flow, posing performance risk.[4] In addition, high interest rates are already making it difficult for some CMBS properties to refinance, potentially creating maturity defaults.

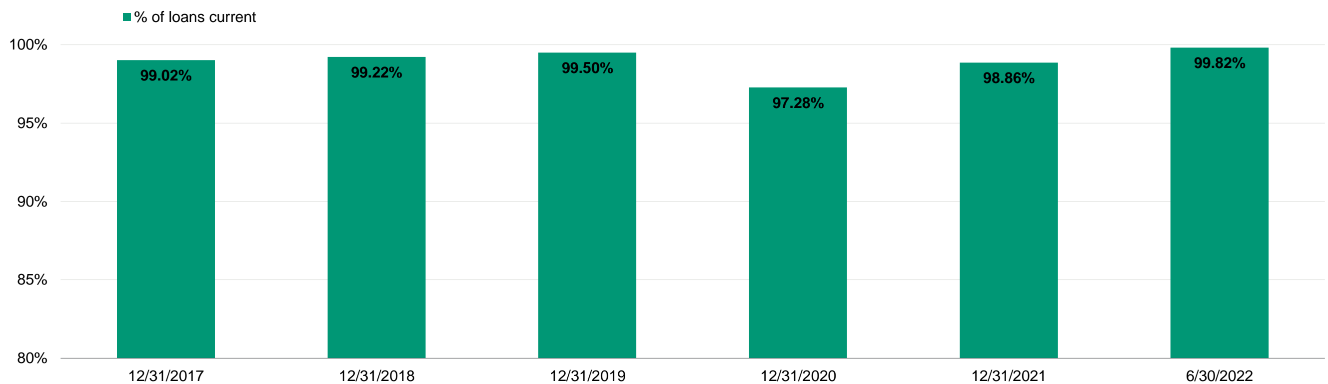
These property and market level factors will deplete margins for some multifamily properties even as strong fundamentals support overall performance. Lowered cash flow will weaken some of these borrowers' ability to make payments and obtain new financing, especially given recently increased interest rates.

Housing Finance Agency: Strong affordable housing demand supports multifamily portfolios

Housing Finance Agency (HFAs) multifamily programs' portfolios are performing very well because of strong demand for affordable housing (see Exhibit 15) and we expect that to continue. High home prices, high mortgage rates, and the shortage of single-family housing stock at affordable prices for low-to-median income homebuyers resulted in a very strong demand for affordable housing developments. Rising rents during the pandemic also supported occupancy for the lower-rent developments financed by HFA.

Exhibit 15

HFA multifamily delinquencies return to pre-pandemic levels



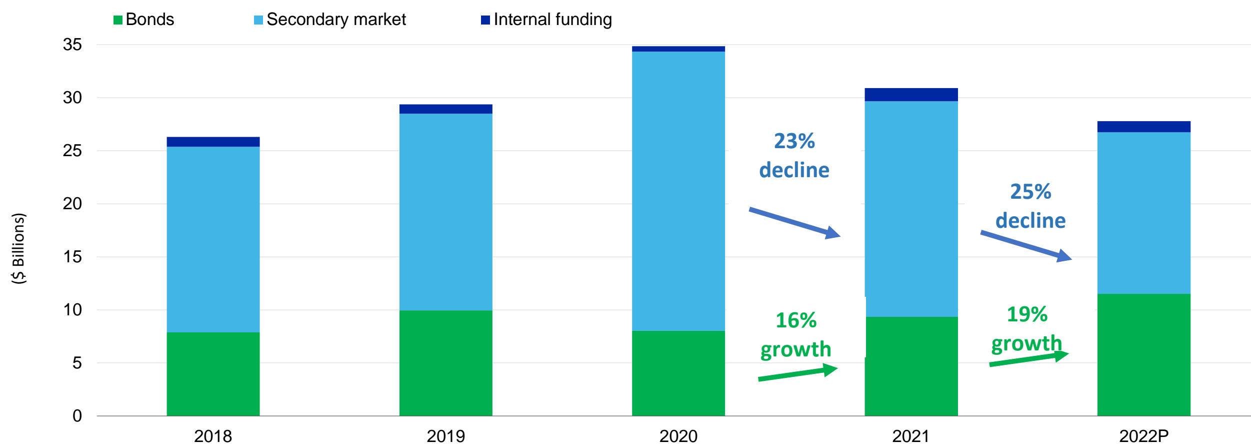
Source: Moody's HFA Surveys

HFA multifamily performance remained resilient throughout several crises, including the pandemic, because of strong subsidies as well as support for renters through the Treasury's Emergency Rental Assistance program. The HFA portfolio is highly subsidized (approximately 50%) through federal programs such as Section 8 project-based subsidies, which allows developments to benefit from rent collection, even during times of economic stress. Beyond subsidy, HFA portfolios are supported by credit-enhancement and mortgage insurance. Over 40% of the HFA portfolio we rate is credit enhanced with guarantees from Ginnie Mae, Freddie Mac and Fannie Mae. All of these enhancements insulate projects from potential loan loss for the HFA.

On the single-family side, price appreciation and elevated mortgage rates will continue to slow HFA mortgage originations (see Exhibit 16). However, we do expect HFAs to continue to finance a substantial volume of loans, returning closer to pre-pandemic levels. HFAs will shift their financing mechanism toward the use of tax-exempt Mortgage Revenue Bonds (MRB) to provide a lower cost of funding, translating to more competitive mortgage rates to first-time borrowers.

Exhibit 16

HFA originations will slow because of declining affordability



Source: Moody's HFA Surveys

Endnotes

1 Of note, the share of COVID NCF loans only tracks loans that became delinquent because of the pandemic since March 2020; therefore, there is no data for the period from December 2017 to March 2020. COVID NCF loans: (1) loans not liquidated but which took a loss in the reporting period (to capture loans with monthly deferrals that were reported as current); or (2) loans have actual balances increased in the reporting period; or (3) loans have actual balances unchanged in the last and current reporting period, excluding interest-only loans and pay ahead loans. The calculation of COVID NCF loans was updated since the Q3 2021 sector update to exclude loans with an unchanged balance for just one month, possibly because of payment delay.

2 CMBS – US: Red-Yellow-Green™ – Q4 2022 assessment of US property markets, 17 March 2023.

3 CMBS-US: Moody's DQT - Conduit/Fusion DQT remains stable for eight months after two years of declines, 11 April 2023.

4 CMBS – US: Rising emissions regulations for commercial real estate pose cash flow risks, 16 November 2022.

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