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Unlocking home equity values

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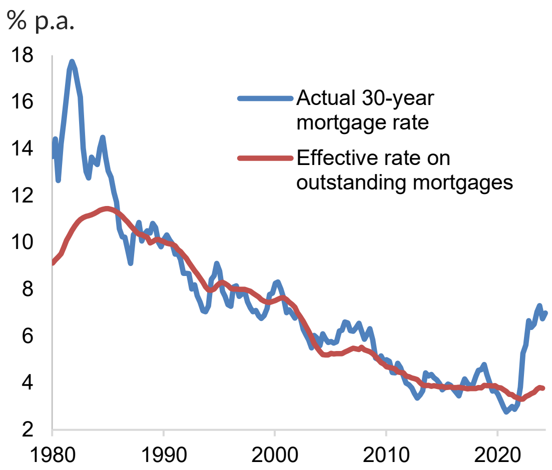
Summary

- US homeowners' total real estate equity value exceeds $30 trillion ...
- ... but much of that is locked in due to the rise in interest rates
- Second-lien mortgages allow home-owners to unlock some of that home equity value ...
- ... and offer attractive opportunities for investors

Securing low mortgage rates in the years before the Fed started to tighten policy is one reason for the resilience of the US economy.[1]

On the flip side, most home-owners are effectively locked in as prevailing mortgage rates are much higher than the effective interest rate they currently pay on their outstanding mortgages (see Chart 1).

Chart 1: Mortgage interest rates



Source: Bureau of Economic Analysis and Freddie Mac.[2]

We estimate that financing a similarly priced home would increase debt-service payments for existing homeowners by as much as 50% depending on the interest rate and remaining duration of the initial mortgage. Not surprisingly, existing home sales have dropped nearly 40% since the peak in 2021.[3]

Given our view that interest rates will stay higher for longer, the lock-ins are likely to prevail for some time. That means that a lot of the home equity value is unlikely to be used for home acquisitions, which impacts both individual households as well as the housing market and the economy as a whole.

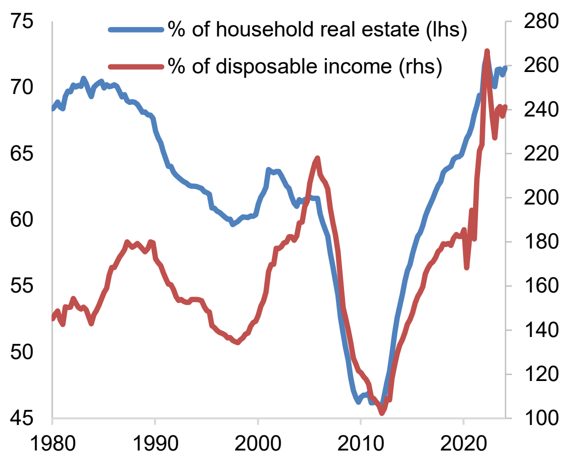
More than $30 trillion of home equity

Based on the latest data from the Federal Reserve, the aggregated value of homeowners' equity in real estate is around $32.8 trillion, up 300% over the last twelve years.[4]

In relative terms, the share of homeowners' equity in household real estate has increased by 25 percentage points since the financial crisis to over 70% (see Chart 2).

Chart 2: Homeowners' equity in real estate

% share



Source: Board of Governors of the Federal Reserve, Bureau of Economic Analysis and Census Bureau.[5]

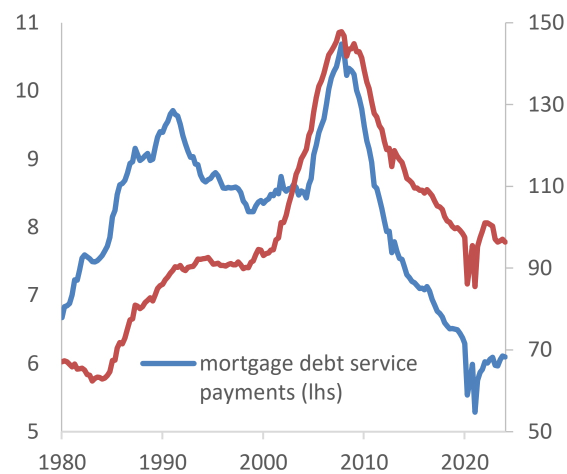
That implies that the loan-to-value ratio of outstanding mortgages has dropped below 30%. Relative to disposable income, the share of homeowners' equity in household real estate has more than doubled over the last twelve years and currently stands well above the highs seen before the financial crisis (see Chart 2, again).

Deleveraging has played an important role in the rise of homeowners' equity in real estate. Following the financial crisis, household mortgage debt fell for several years and rose only modestly thereafter.[6]

Relative to disposable income, household mortgage debt fell from the peak of nearly 150% during the financial crisis to less than 100%, which also helped push the debt-service ratio to a historical low (see Chart 3).

Chart 3: Mortgage debt and payments

% of disposable income

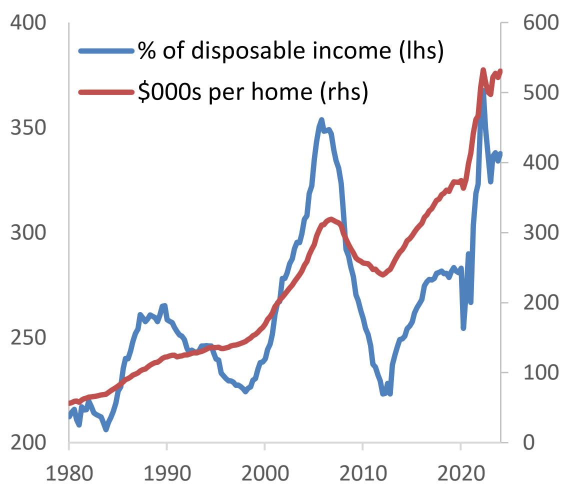


Source: Board of Governors of the Federal Reserve, Bureau of Economic Analysis and Census Bureau.[7]

Not a bubble

The other factor behind the rise of homeowners' equity in real estate is home-price appreciation. Home values more than doubled over the last 12 years, boosting its share of disposable income to levels last seen in the years prior to the financial crisis (see Chart 4).

Chart 4: Average home values



Source: Board of Governors of the Federal Reserve, Bureau of Economic Analysis and Census Bureau [8]

The lofty valuation naturally triggers bubble concerns and raises doubts whether the high value of homeowners' equity is sustainable.

In our view, however, a dangerous bubble only emerges if high home valuations are accompanied by an excessive rise in leverage and housing construction.

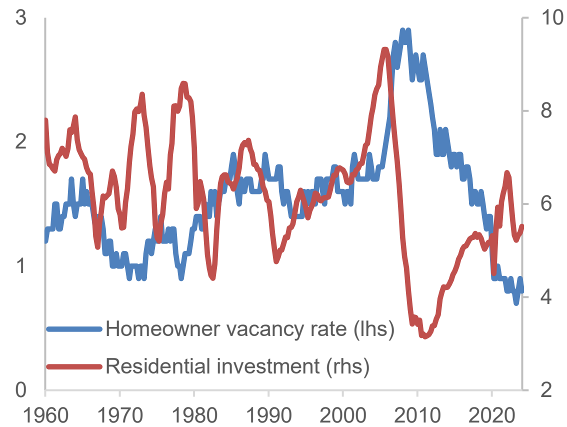
Yet, as we pointed out before, leverage has actually declined and housing construction activity is not strong by past standards, which is also reflected in low vacancy rates (see Chart 5).

If housing was in a bubble, then Fed tightening should have pricked it and boosted mortgage delinquencies. That did not happen: more than two years after the Fed started to hike interest rates mortgage delinquency rates are still below 1%.[9]

This resilience is also supported by the much higher credit standards that have prevailed since the financial crisis.[10]

Chart 5: Housing construction and vacancy

% (lhs) and % of disposable income (rhs)



Source: Bureau of Economic Analysis and Census Bureau. [11]

Instead, we believe that high home values result from a shortage of housing and firm underlying demand. Indeed, our home price model, which is based on demand and supply factors, suggests that home prices will rise around 3% annually over the next one to two years.[12] As a result, we expect homeowners' equity values to rise further.

The return of second-lien mortgages

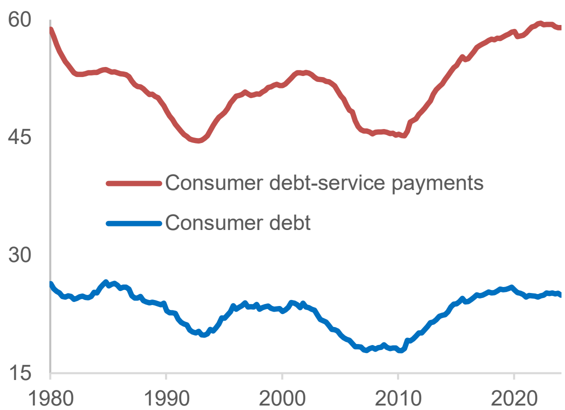
The disparity between effective and prevailing mortgage rates has made it very difficult for homeowners to extract and use existing home equity as a means of facilitating new home purchases. However, we see ample opportunity for homeowners to use second-lien mortgages to fund discretionary spending and to improve their financial position by refinancing expensive consumer debt balances.

Indeed, while consumer debt makes up roughly a quarter of total household debt, consumer debt-service payments account for nearly 60% of total household debt-service payments (see Chart 6 on next page).

Inversely, mortgage debt-service payments account for just 40% of total household debt-service payments, while mortgage debt makes up about three quarters of total household debt.

Chart 6: Consumer debt and debt-service payments

% of total household debt & debt-service payments



Source: Board of Governors of the Federal Reserve [13]

The main reason for the difference between mortgage and consumer debt and their respective share of debt-service payments is interest rates. The market lends at a significantly lower rate on a secured versus an unsecured basis. The discrepancy is most striking between mortgage and credit-card debt. The effective interest rate on all outstanding credit card debt is currently above 21% while the effective interest rate on existing mortgages is less than 4%.[14]

Based on our calculations, a homeowner whose property appreciated by at least 20% since purchase and with a 30-year mortgage for $400,000 at 3% could take out a 20-year second-lien mortgage for $100,000 at 9% and pay on the combined balance an effective interest rate of around 4.7%.

We estimate that this would reduce the overall interest rate on the total debt by up to 2 percentage points if the homeowner uses the second-lien mortgage to retire more expensive consumer loans.

Of course, second-lien mortgages are not a new concept. Home equity loans (HELOAN) and home equity lines of credit (HELOC) have been around for many years.[15]

Furthermore, the opportunity likely is smaller than the aggregated figures suggest, as home-owner and debt profiles vary significantly across household, age and income groups. Especially, the homeowner-ship rate increases with income, while the debt-service burden of consumer loans falls with income.[16]

Regulations on second-lien mortgages have also been tightened since the financial crisis, and tax incentives, such as the ability to deduct interest payments on second-lien mortgages, have been reduced.[17] Still, we expect that the demand for second-lien mortgages will rise if, as we expect, interest rates stay higher for longer.

Attractive investment opportunities

The FHFA recently provided conditional approval for a pilot program that will allow Freddie Mac to purchase second-lien mortgages subject to certain limitations for a total of $2.5 billion.[18]

We believe this is a good development for the market. On the one hand, having Freddie Mac as a reliable purchaser of second-lien mortgages should incentivize more high-quality origination of such product. On the other hand, with an initial cap of $2.5 billion, which we think is a small percentage of the potential size of issuance, there should not be a big crowding out of private capital.

There are various options for investors to enter the second-lien mortgage market, such as closed end second-lien mortgages.

In our view, second-lien mortgage products offer investors compelling and diversified returns relative to competing loan and securitization products. Given the high creditworthiness of the borrowers, the built-up home price appreciation and still relatively low combined leverage, we think second-lien mortgage products can provide strong returns relative to the risk.

More information

As always, we are available to discuss our views with you. Please contact your Client Relations representative at +1 732 978 9722 or zais.clientrelations@zaisgroup.com

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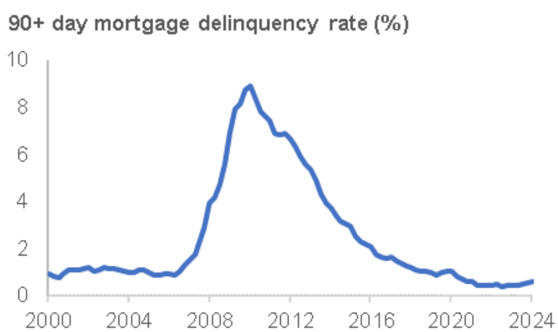

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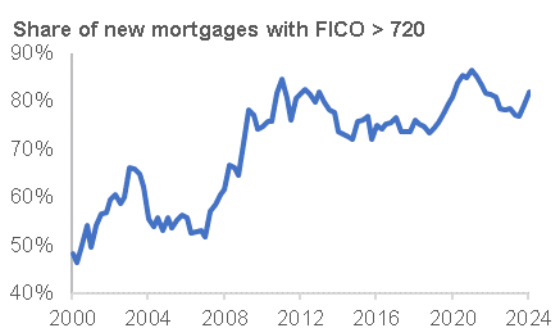

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