BY BILL BERLINER

Housing and the MBS Market

Given the importance of housing to MBS credit and prepayment performance, MBS investors have always kept one eye on trends in national and regional real estate markets. As recent data suggest that housing is finally rebounding from the severe slump of the last half-decade, investors and originators need to contemplate how a sustained housing recovery might impact the different segments of the MBS markets.

There are a variety of indicators pointing to a general recovery in home prices and residential real estate activity. The **National Association of Home Builders** Index, a crude yet telling number, is at its highest level since May 2006; both new and existing home sales have also trended higher, suggesting an uptick in activity. Home prices have also shown broad-based strength. Illustrating the breadth of the recovery, 124 of the 154 metro areas reporting median home prices to the **National Association of Realtors** (NAR) experienced year-to-year price increases in the third quarter of 2012. A number of prominent economists have called for housing to lead the economy in 2013, although the outcome of the "fiscal cliff" negotiations will certainly impact housing and real estate.

There are several factors driving the recovery. Realtor inventories are relatively low; according to the NAR, the current supply of 5.4 months is less than half of its mid-2010 peak. The overhang of foreclosed properties has also been reduced. According to data from **CoreLogic**, the number of homes in foreclosure is 20% less than at its peak in January 2010.

In addition, it is likely that historically low mortgage rates have broadly supported home prices.. Affordability remains close to all-time highs, with lower borrowing costs offsetting higher home prices. Despite skepticism, the Fed's multiple MBS purchase programs have given support to home prices by pushing consumer mortgage rates lower.

Despite the positive trends, the housing recovery will remain uneven. According to CoreLogic, just under one million homes remain in foreclosure. Moreover, the resolution of many foreclosures has been delayed in "judicial" states by the judicial review process. According to **Lender Processing Services** (LPS), inventories of foreclosed loans in judicial states are triple those of non-judicial states, and their foreclosure timelines are significantly longer. This will weigh on judicial state home prices; in addition to the incremental supply, home prices in markets with large numbers of foreclosed properties are typically depressed by the concession at which repossessed homes trade.

A continued recovery in home prices will likely result in a broad-based increase in agency prepayment speeds.

Assuming that the recovery can be sustained, rising home prices will materially impact the various MBS markets. Non-agency MBS should continue their steady improvement, primarily reflecting expectations of better credit performance. In the agency sector, rising home prices will likely result in a broad-based increase in prepayment speeds. Sustained home price appreciation will reduce borrower LTVs while helping some underwater borrowers rebuild their equity interests, pushing overall prepayment speeds higher.

In a regime of near-record price premiums for agency MBS, a general increase in prepayment speeds would normally translate into weaker price performance and wider spreads. With the Fed buying virtually all net MBS production, however, I expect MBS prices to remain at elevated levels, further stoking demand for the prepayment protection offered by specified pools. In particular, the combination of faster speeds and positive home price appreciation should create strong demand for attributes not directly affected by changing home prices, such as small-balance pools. I also expect increased focus on geography as a variable. Pools backed by loans originated in judicial states, in particular, should experience tepid real estate appreciation and slower prepayment speeds.

Bill Berliner is Executive Vice President of Manhattan Capital Markets. He is the co-author, with Frank Fabozzi and Anand Bhattacharya, of the recently- released second edition of Mortgage-Backed Securities: Products, Structuring, and Analytical Techniques. His email address is bill_berliner@manhattancapitalmarkets.com.