Guest Commentary, by Gene Spears

Mortgage Refi as a Liquidity Vehicle

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Gene Spears is a biology professor at Lees-McRae College in North Carolina who spends way too much time reading about economic matters.

In his book, *The Dollar Crisis*, Richard Duncan engages in a little rhetorical Q&A. "When (will the global recession hit)? When the U.S. property bubble pops." This is the kind of simple, unambiguous answer that is rare in most financial books, and it inspired me to begin to more closely follow the U.S. mortgage market. Fortunately, the World Wide Web has made this relatively easy to do.

The Mortgage Bankers Association maintains a web page with historical data on mortgages that goes back to 1998 and is updated on a weekly basis (http://www.mbaa.org/news/weekly_app.html). Weekly reports contain a Purchase Index (measuring new mortgage applications) and a Refinance Index as well as a Combined Index, and data on fixed and variable mortgage rates. I have used these data to construct a couple of graphs, included below.

Graph 1 shows the relationship between the Refinance Index and the 30-year fixed interest rate from 2001 until the present. To make the relationship more easily visualized, I inverted and scaled the 30-year fixed rate.[1] This means that a drop in interest rates will cause the graph line to rise and that the scale of change is proportional to the scale of change in the Refinance Index over this time period. (The highest peak and the lowest trough in the Refinance Index will be about the same height as the peak and trough in the inverted 30-year fixed rate.) Note the remarkable correspondence between 30-year fixed rates and refinancing (at least until August of this year – more on

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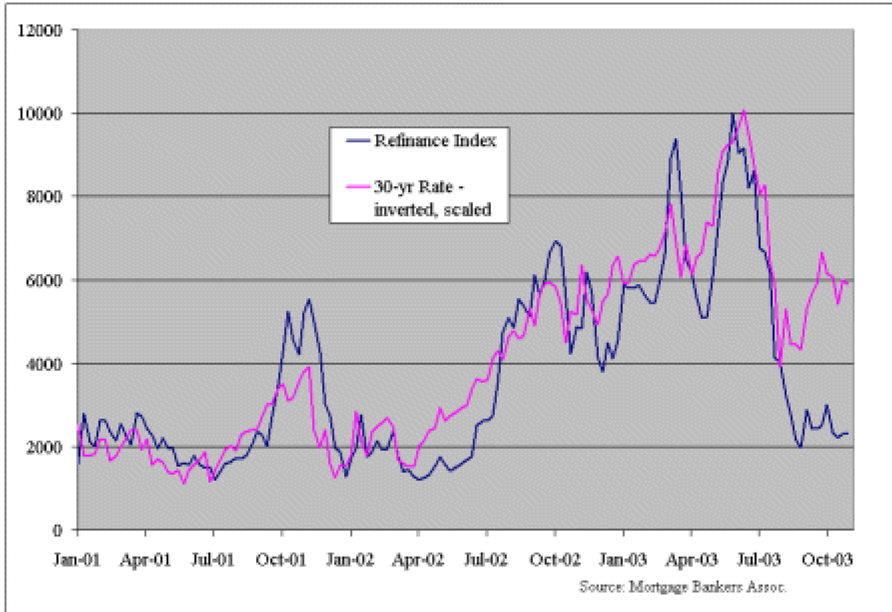
this later). Not surprising, really, that homeowners have finely tuned antennae where interest rates are concerned.

Graph 1



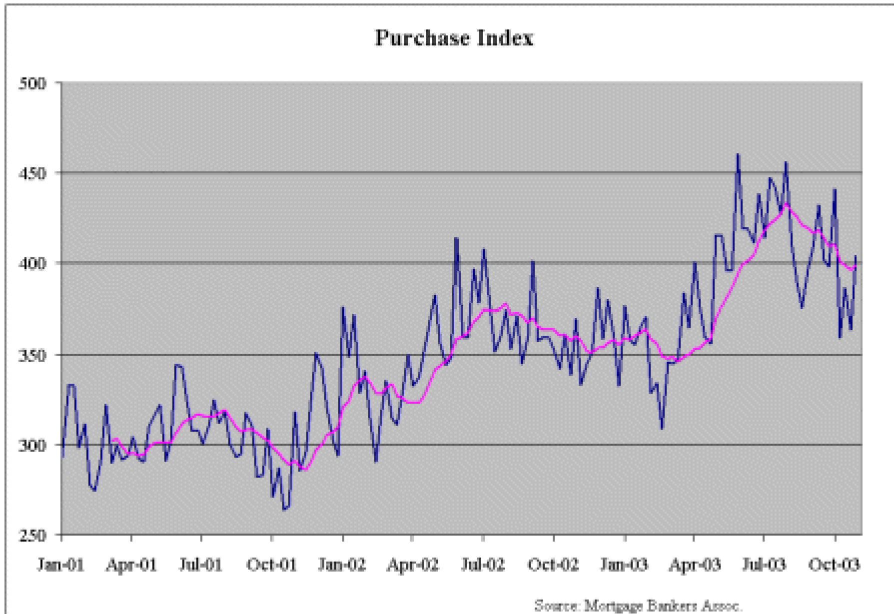
Although mortgage refinancing is mentioned frequently as a source of economic stimulus, I don't think the general press has given it enough credit for keeping the consumer afloat. The Homeownership Alliance (http://homeownershipalliance.com) published a report in December 2002, *The Economic Contribution of the Mortgage Refinancing Boom*. The authors estimated that approximately $2.5 trillion in mortgage refinancing would be done between 2001 and the end of 2002. Cash-out refinancing (equity extraction) was estimated to be about $170 billion in 2002, about 13.5% of the total amount refinanced. The Homeownership Alliance estimates that over half of the cash-out amount went directly into spending, and about one-third of the cash-out amount went to pay off high interest debt, like credit card debt, thereby supporting future consumer spending. This is a lot of money.

I haven't seen figures for 2003, yet, but a quick look at graph 1 tells us that the real boom in refinancing was in the first half of 2003, so it's safe to conclude that mortgage refinancing contributed even more to consumer spending through the first half of 2003. Since it can take up to 90 days for refinance money to work its way through the economy, I think the mystery of the huge jump in third quarter GDP is at least partially solved.

Mortgage refinancing and, to a lesser extent, new mortgages, play crucial roles as "**liquidity vehicles**" in our economy. The Fed can create all the liquidity (credit) it wants, but it needs vehicles to take the liquidity from the banking system into the broader economy. Mortgage refinancing is a great, big bus of a liquidity vehicle. Every homeowner can take advantage of it (and by the end of 2002 the Homeownership Alliance estimated that 40% had), and it puts money directly into the hands of the consumer. Since consumption makes up between 67-90% (depending on who you read) of our economy, it's a sure-fire boost to economic indicators.

New mortgages are another important liquidity vehicle. Here, the liquidity doesn't go to the homebuyer, but to the contractors, suppliers, realtors, and others who built and sold the house. But since the pool of new homebuyers is much smaller than the pool of existing homeowners, this vehicle can't carry nearly the load that the refinancing bus can handle. Here, too, we have seen a peak in new mortgage activity and a gradual decline (Graph 2 – actual Purchase Index and smoothed 10-week moving average).

Graph 2



The decline in both Indexes, steep in Refinance, more gradual in Purchase should cause serious concern to… everyone, really. The data indicate that mortgage activity has injected a tremendous amount of money into our economy over the last 2-3 years. That source now appears to be running dry.

Take a look at the last few months of refinance activity and interest rates (graph 1). Interest rates are now at levels (5.6-6.0%) similar to those at the beginning of this year and in September of 2002. These were times of heavy refinance activity. Not now. Current refinance levels are closer to those found when interest rates were above 7%. This suggests that the demand for refinancing has been largely met.

Even if the Fed were somehow able to make the 30-year fixed rate fall significantly (though this seems unlikely), the surge of demand for refinancing is likely to be much more subdued this time around. Even if requirements to qualify as a homebuyer are relaxed (as appears to be in the works), and purchase applications pick up, it's not going to make up for the much larger decline in refinancing. Remember that the U.S. economy benefited by both record refinancing levels **and** record purchase levels during the first three quarters of 2003. A return to these record levels seems unlikely, given the drop in long-term interest rates that would be required.

Something Wicked This Way Comes (apologies to William Shakespeare)

Let's construct a possible future scenario given the information above. Despite the best efforts of the Fed to keep the credit flowing, little of the nourishing flow makes its way into consumer hands. With wages and salaries flat or declining, a heavy debt load, and the home equity well running low, consumer spending begins to slacken. The demand for goods, both domestic and foreign, drops. The trade deficit gets better, but the flow of dollars into exporting countries, especially China, Japan and the rest of Asia, slows. With fewer dollars to soak up, these nations reduce the amount of dollars they plough back into U.S. investments (government and GSE bonds primarily).

With reduced demand for it's debt, the Fed is in a quandary. In order to make our debt more attractive, interest rates would need to rise. This would strengthen the dollar, but add more stress on the consumer, inspiring further cutbacks in spending, further reducing the flow of dollars into exporting countries, further cutting back on the flow of dollars into U.S. debt instruments, etc., etc. The so-called "virtuous cycle" of U.S. dollars buying external goods and being returned to us is replaced by a vicious positive feedback cycle that reinforces itself and runs out of control. End result – global recession. Growth both home and abroad grinds to a halt.

Could the Fed replace the exporting countries as buyers and purchase enough of the government's own debt to keep the ball rolling? Can they find another way to get credit into the consumer's hands? Who knows? I'm not sure there are any limits to what you can do with a fiat currency that is also the global reserve currency. It makes my head hurt to think about it too much. Whatever market intervention they contemplate would have to be on a massive scale to replace the amount of refinancing liquidity that has already gone over the dam. I suspect such large-scale and obvious intervention would rattle both domestic and foreign markets, and hasten the decline of the dollar and the flight from U.S. assets.

If the above scenario has any relationship to reality, we should see signs of consumer spending slowing, money flow slowing, and pressure building on interest rates. Given that the Refinance Index crashed in August, our thumbs should begin prickling soon.

[1] The formula for the modification of the 30-year fixed rate (IR) is as follows: 1500 +((1/IR-0.140) *142,000).

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