October 2018

A Changing Economy

Three Ways Community Lenders Can Stay Ahead

Harry Truman once quipped that he wanted a "one-handed economist" after growing exasperated with the "'on one hand…on the other hand'" briefings from his advisors. Anyone trying to predict the direction of today's economy can probably relate to Truman's frustration. And, as we enter the 10th year of an economic expansion, the stakes are high for homebuyers and lenders.

Despite a healthy economy, higher interest rates and tight housing inventory are making it harder for people to buy homes and for community lenders to grow their mortgage businesses. However, lenders can overcome these obstacles by embracing technology to operate more efficiently and help borrowers get into homes, while also strengthening their balance sheets.

A Robust Economy, Despite Headwinds

This economic expansion is the second-longest one on record, with only the period from 1991-2001 exceeding it. GDP is robust, unemployment is near historic lows, and consumer spending is holding steady (read our September forecast to learn more). However, economists are concerned about the Federal Reserve's plan to keep raising short-term interest rates to calm inflation – now at a six-year high. They'll be watching to see whether higher rates cause the bond yield curve to invert, which usually indicates that a recession is on the horizon.

Housing Market Reflects Tight Supply, High Demand

In terms of the housing market, the biggest problem besides higher interest rates is that housing construction hasn't kept pace with demand. New home building remains well below pre-2008 levels. Adding to the problem is a builder focus on high-end properties during this recovery, rather than on starter homes, two- to four-units, or manufactured housing.

With only a lukewarm rebound in construction and increased consumer demand tied to strong job growth, home prices are continuing to rise despite mortgage rates having jumped over half a percent this year. However, higher rates could moderate home price growth and make it somewhat easier for prospective homebuyers who are currently within reach of the market. We predict that home prices will increase by 5.5% this year, down from 7.2% in 2017.

Challenges Confronting Home Builders

There are three main reasons why home building has slowed and builders have chosen to focus on higher-priced homes. They're what builders call **the three "Ls"—labor, lots and lending.**

Labor

An acute **labor** shortage of construction workers has increased builders' costs.

Lots

With a shrinking number of available **lots** in desirable areas and costly municipal fees to develop them, builders have refrained from putting up more affordable homes and focused on higher-end properties that typically generate higher profit margins.

Lenders

Because of housing-related wealth destruction during the Great Recession, **lenders** are more reluctant to finance the construction of homes at the middle or lower end of the market.

With builders focused on higher-priced homes, community lenders are hard pressed to get first-time home buyers and middle-income borrowers into homes they can afford. Loan officers are having to collaborate more closely with real estate professionals to find less conventional financing solutions to get clients to the closing table.

Homeownership Achievable Despite Barriers

Despite the obstacles, the dream of owning a home is still within reach—particularly for millennials—who overtook baby boomers as the nation's largest generation in 2015, according to the U.S. Census Bureau.

College-educated millennials stand to increase their earning power in coming years and overcome the obstacle of student debt—which eats up about 7% of their current income.

While burdensome, college or graduate school debt is an investment in one's human capital. It delays homeownership but doesn't preclude it. Over time, the homeownership rate of college graduates eclipses those with only a secondary education.

Millennials are most likely to buy a home when they reach the 32- to 38-year age bracket, with many in this generation nearing this milestone. As the majority of millennials grow older, they're expected to close the gap on household formation and will be more driven to jump into homeownership.

A Three-Pronged Strategy for Community Lenders

For mortgage lenders, current market conditions are challenging. The spike in rates has cratered homeowners' desire to refinance, resulting in what we forecast will be a 8.9% decline in total origination volume to $1.65 trillion for 2018. However, there are ways to weather this tough business climate and even grow your client base:

Leverage Low Down Payment Options: Due to a combination of factors, homeownership remains out of reach for a lot of people who can't put 20% down on a home. However, low down payment solutions give lenders more flexible financing options. For example, Freddie Mac's HomeOne® and Home Possible® loans allow borrowers to put as little as 3% to 5% down. For some people, such loans can make the difference between owning a home and continuing to rent.

Explore Fintech Solutions: With production for a single loan costing nearly $9,000, lenders need to find ways to operate more efficiently and reduce costs. Financial technology (fintech) companies are stepping up with solutions to drive efficiencies in the marketplace. LoanBeam, for example, automates self-employed borrower financials from tax returns and other relevant data, and then calculates an income total. And Finicity has an automated income and asset verification process that can significantly reduce closing time and origination costs.

Review Your Portfolio: With interest rates expected to climb higher, the time is ripe for lenders to analyze their loan portfolios with an eye toward boosting net interest margin income. Restructuring their balance sheets is one way to get this done. Freddie Mac can review loans held in a portfolio, tell you which ones are saleable and provide pricing so you know where you stand.

Traversing A Changing Landscape

Today's economy is humming along, and economists are forecasting steady growth for the rest of this year and 2019. But the economic consensus indicates a potential slowdown in growth in 2020. This medium-term positive outlook, coupled with impressive job growth, is helping Americans to feel more optimistic about becoming homeowners.

While the mortgage industry faces headwinds, there is good reason for community lenders to feel confident about the future. They can tap resources designed to help borrowers who are within reach of the market, gain a competitive edge with new technology and optimize their loan portfolios to take advantage of higher interest rates.

For more information on this topic and others, visit www.freddiemac.com.