

Is It Time To Turn The Truck Around?

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It is a tried and true statement that in the market place you tell the tide will turn when the last player gets on board. These darkest before the dawn moments often cause people to “Buy High” or “Sell Low”. It is one reason why business schools preach on the need to be well-capitalized to ride out the troughs in a particular business cycle. Many fortunes have been made by seizing upon these turning points.

The market for mortgage servicing assets (MSAs) or rights (MSRs) seems to be setting up as a case in point. This market started out with too many investors miscalculating the life cycle of mortgages, the cost to hedge them and without a viable strategy for managing the value of the assets. The market fell into another truism of free-markets. The market will seek out and devour the weak. This can turn into feeding frenzy, such as the one we have witnessed over the past few years.

Those that would choose to explore seizing the turning point in the MSA market must be devoted students of the life cycle of the relationship between a residence (the collateral) and the homeowner. Some tendencies that may be observed. The percentage of homeowners and absolute number of homeowners is growing in the United States. The life expectancy of Americans continues to increase. By some estimates homeowners tend to change addresses every 7 to 9 years. Home prices continue to rise.

The MSA market opportunist must also be a student of the markets. When mortgage market rates move 50bps lower than the borrower's mortgage rate it tends to trigger significant refinancing activity. A drop of 100bps opens the flood gates. Should rates move lower from their current levels at 5.10 yield for a 30 yr MBS the incremental incentive to refinance decreases. A rule of thumb (some thumbs are better than others) the incremental payment savings of each 50 bp drop in rate is worth about 95% as much as the previous 50 bp drop. What can be drawn from that? It will take increasingly larger drops in note rate to trigger a refinancing spirit. Mortgage Spreads over Treasuries have room to shrink as capacity efficiencies allow / force mortgage conduits to become more aggressive in pricing.

Technology continues to improve mortgage banking productivity. Inflation rates are mild, by some estimates below 2%. This will mean that more loans can be produced and serviced per employee. Conversely the cost per loan to service will continue to decline. This in concert with higher home prices would indicate that the monthly servicing income spread would increase.

As we are at 40 year low on many credit market yields, one might ask can they go any lower? The potential MSA investor must ask this question each time a bid is posted. If we look at the current scenario, 1mo T-Bills are near 1.20%, 5yr T-Notes are near 2.90%, and 30 yr MBS yields are generally felt to be near 5.10%. The latter is trickier because the yield here is predicated upon prepayment expectations.

It would seem that the market is requiring (or implying) a 1.70% spread to compensate for inflation risk for 5 year Treasuries and a 2.20% spread for MBS. The 30 Year MBS, currently tend to have the price sensitivity of a five year non-callable instrument. From this vantage point, should short rates remain steady there would seem to be a surprising amount of potential for rates to move lower.

In the next installment we will consider the MSA market further and explore an investment /

hedging strategy called “Clustered Borrower Retention”.

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