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ANDREW DAVIDSON & CO



Credit Insights Through the Pandemic: Crosscurrents

OCTOBER 2020

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MID-YEAR MARKET OBSERVATIONS: Crosscurrents



- Economic dislocation continues at depression-era levels, with no end in sight.
- The housing market has remained remarkably resilient with rising prices, low supply, and active purchase and refinance markets.
- Financial markets have stabilized since the peak of the pandemic shock—so far—and Mortgage Debt Outstanding (MDO) is growing; mortgage rates continue near generational lows.
- Spreads in traded markets dramatically widened and have recovered ~70% of their pre-pandemic levels.
- Non-agency mortgage share, including banks, shrank dramatically and related rates widened.
- Mortgage credit has tightened as measured by Optimal Blue data for LTV, FICO and DTI.
- Homeownership rates have risen this year, even for minority households.

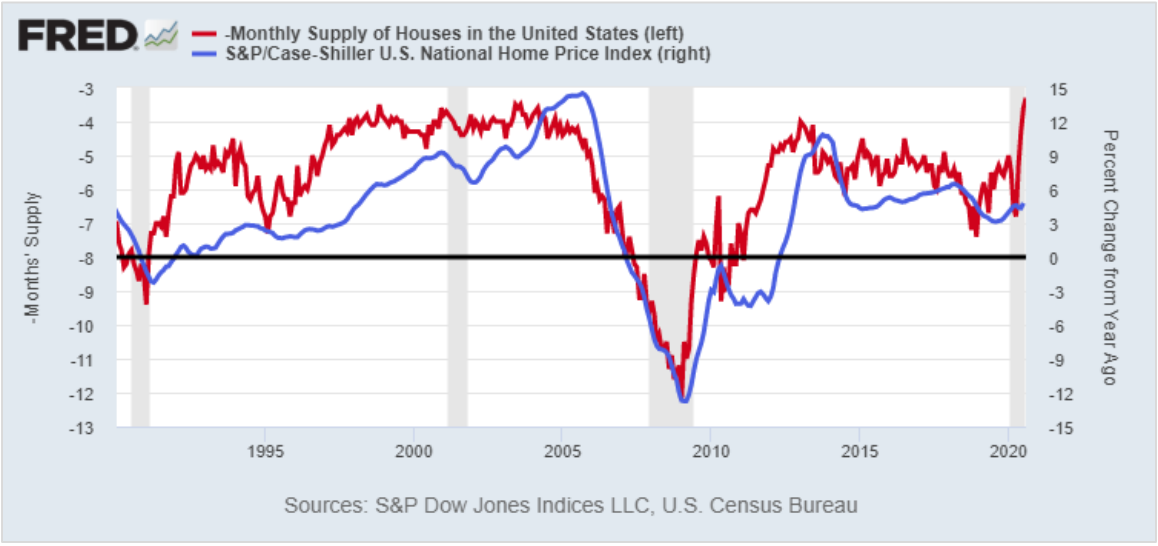
INTRODUCTION

Andrew Davidson & Co., Inc. (AD&Co) has sourced data from Optimal Blue, now part of Black Knight, to deliver this report titled ***Credit Insights Through the Pandemic: Crosscurrents***. This report leverages proprietary data and analytics produced by both firms to provide insight into mortgage credit availability in the context of market dynamics. Optimal Blue's detailed data on credit attributes of loan locks, combined with market spreads and AD&Co analytics, provide the most up-to-date information on the mortgage market. Further, this report provides insight that is useful to originators, servicers, investors and policymakers on the dynamic interaction of markets and policies. For additional information on the data and analytics contained within this report, please contact AD&Co.

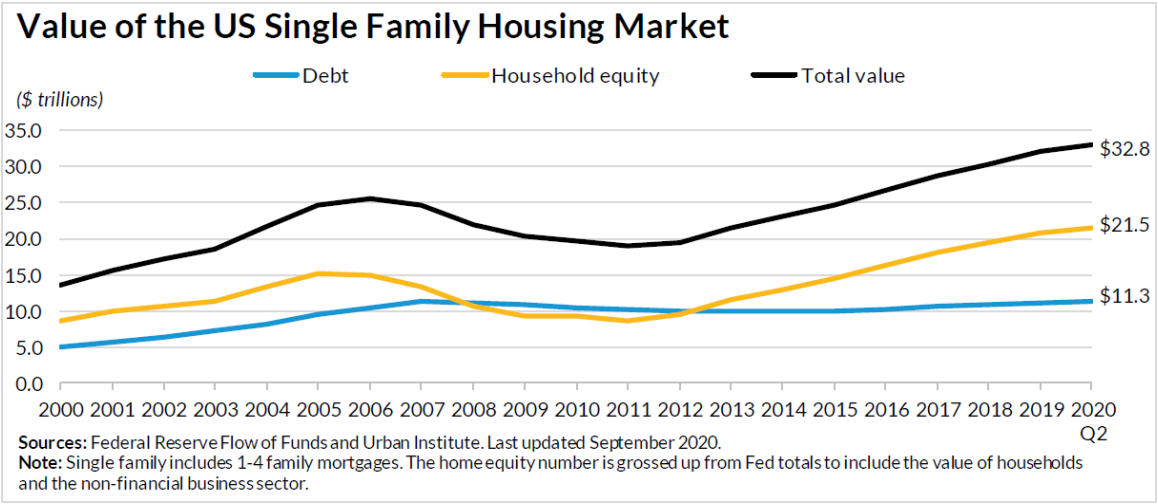
AD&Co and Optimal Blue have mutually agreed to discontinue their collaborative publications. As a result, this report will be the last collaboration. This decision will not impact any other connected solutions, including the use of AD&Co's LoanDynamics Model within Black Knight's CompassPoint Pipeline and Servicing Rights Valuation solution. If you have any questions related to this information, please reach out to your AD&Co and/or Optimal Blue contact.

HOUSING MARKET

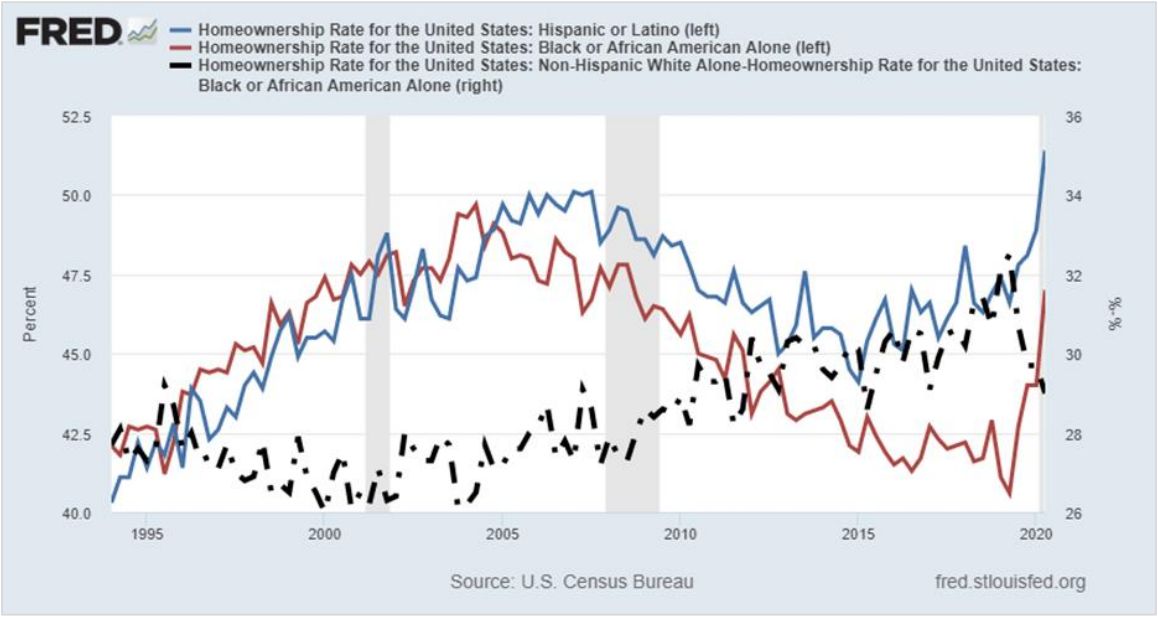
One of the most surprising developments during the COVID-19 pandemic has been the resiliency of the housing market. Data sourced from Optimal Blue shows that purchase and refinance activity have remained high. The combination of supplemental unemployment payments and widespread forbearance has largely eliminated forced selling for the government mortgage market. The graph below shows the long-run relationship between housing supply and housing prices. Supply is tightening and there is little evidence that housing prices will fall in the near term unless these major federal policies change. This sharp contrast to the last financial crisis can be a key driver of keeping housing-related credit losses much lower than the last financial crisis with similar unemployment rates.



MDO has been essentially flat since 2007 but housing values have steadily risen since 2012 and homeowners now have a record $21 Trillion of equity. Ongoing economic stressors may cause more owners to become house rich and cash poor. They may not be forced out of their homes while forbearance continues but may need to sell to liberate liquidity for living expenses. Further, equity is not distributed equally across the homeownership base. Recently originated FHA and VA loans with low down payments will have less equity.

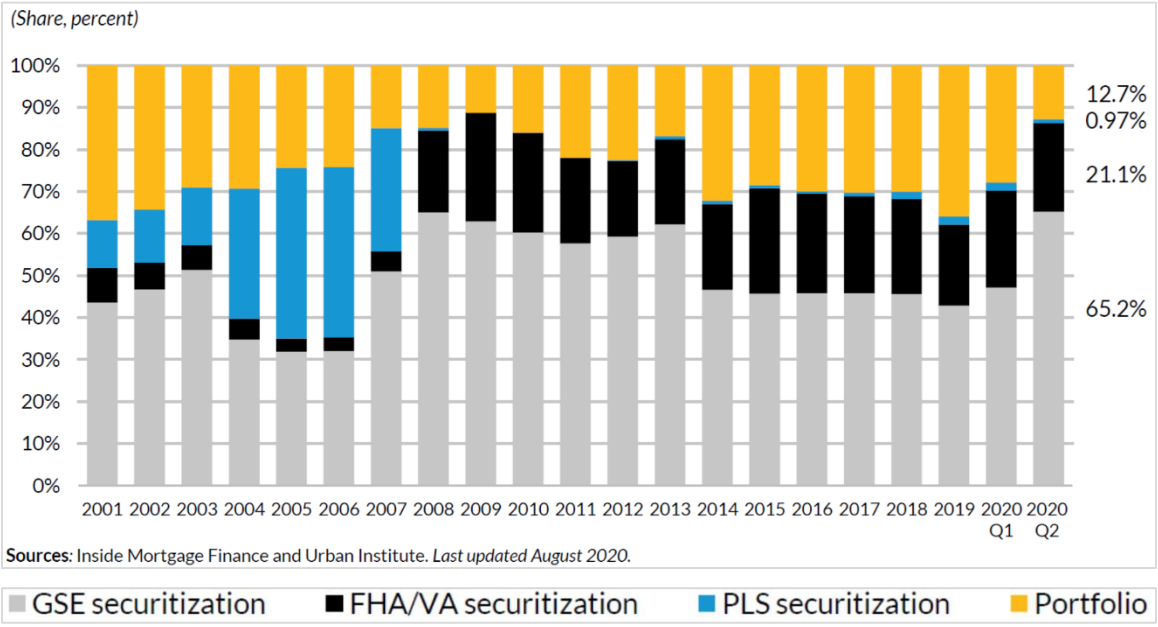


Amid economic dislocation and tightened credit standards, housing supply is low and net Agency MBS issuance is sizably up, as displayed below, as are housing prices. These dynamics lead to an unexpected result; the homeownership rate measurably rose this year—approximately three percentage points. Further, the gap in the homeownership between whites and minorities narrowed, albeit from generationally wide levels. This may arise from a combination of all-time low mortgage rates and increased remote working.

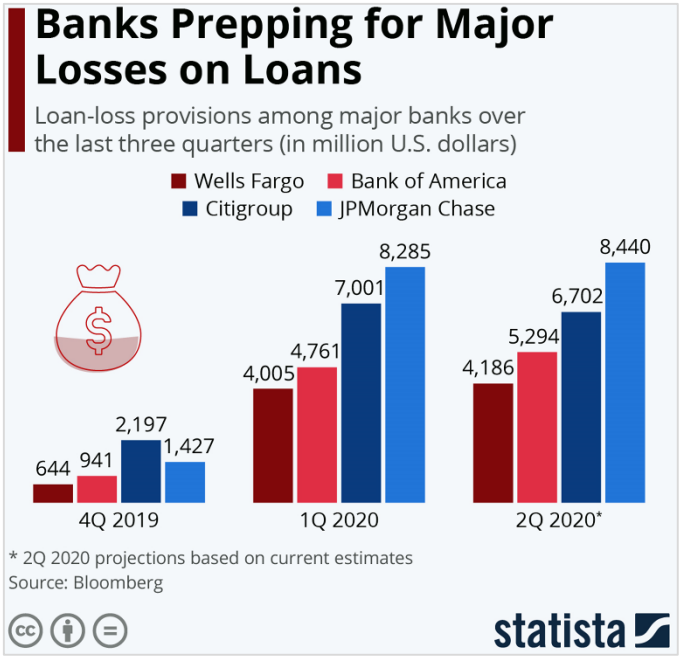


MORTGAGE MARKET

The mortgage market has been red hot most of the year, with record-low mortgage rates despite and because of the COVID-19 pandemic. The refi and purchase markets are at record levels as those still working remotely begin relocating away from coastal megacities or buy houses with home offices. Significantly, bank share of origination has collapsed from 30% to 13%; levels seen only during the prior financial crisis.



It is unsurprising that PLS volume collapsed, but why would banks that are backed by deposit insurance have a precipitous drop? One indicator may be the following: the four money center banks reserved $5 Billion for all credit losses in Q4 of 2019, exploding to $49 Billion for the first half of 2020.



The table below displays a time series of gross and net issuance for the GSEs and GNMA over the past twenty years. Gross issuance should easily break records in 2020, but crucially, net issuance will also be at a record high for the last twenty years.

Agency Gross Issuance

Issuance Year	GSEs	Ginnie Mae	Total
2001	$885.1	$171.5	$1,056.6
2002	$1,238.9	$169.0	$1,407.9
2003	$1,874.9	$213.1	$2,088.0
2004	$872.6	$119.2	$991.9
2005	$894.0	$81.4	$975.3
2006	$853.0	$76.7	$929.7
2007	$1,066.2	$94.9	$1,161.1
2008	$911.4	$267.6	$1,179.0
2009	$1,280.0	$451.3	$1,731.3
2010	$1,003.5	$390.7	$1,394.3

Agency Net Issuance

Issuance Year	GSEs	Ginnie Mae	Total
2001	$368.40	-$9.90	$358.50
2002	$357.20	-$51.20	$306.10
2003	$334.90	-$77.60	$257.30
2004	$82.50	-$40.10	$42.40
2005	$174.20	-$42.20	$132.00
2006	$313.60	$0.20	$313.80
2007	$514.90	$30.90	$545.70
2008	$314.80	$196.40	$511.30
2009	$250.60	$257.40	$508.00
2010	-$303.20	$198.30	-$105.00

—TABLE CONTINUED ON NEXT PAGE—

Agency Gross Issuance

Issuance Year	GSEs	Ginnie Mae	Total
2011	$879.3	$315.3	$1,194.7
2012	$1,288.8	$405.0	$1,693.8
2013	$1,176.6	$393.6	$1,570.1
2014	$650.9	$296.3	$947.2
2015	$845.7	$436.3	$1,282.0
2016	$991.6	$508.2	$1,499.8
2017	$877.3	$455.6	$1,332.9
2018	$795.0	$400.6	$1,195.3
2019	$1,042.6	$508.6	$1,551.2
2020 YTD	$1,374.1	$480.9	$2,117.5
2020 YTD % Change YOY	194.5%	100.4%	199.7%
2020 Ann.	$2,061.1	$721.3	$3,176.3

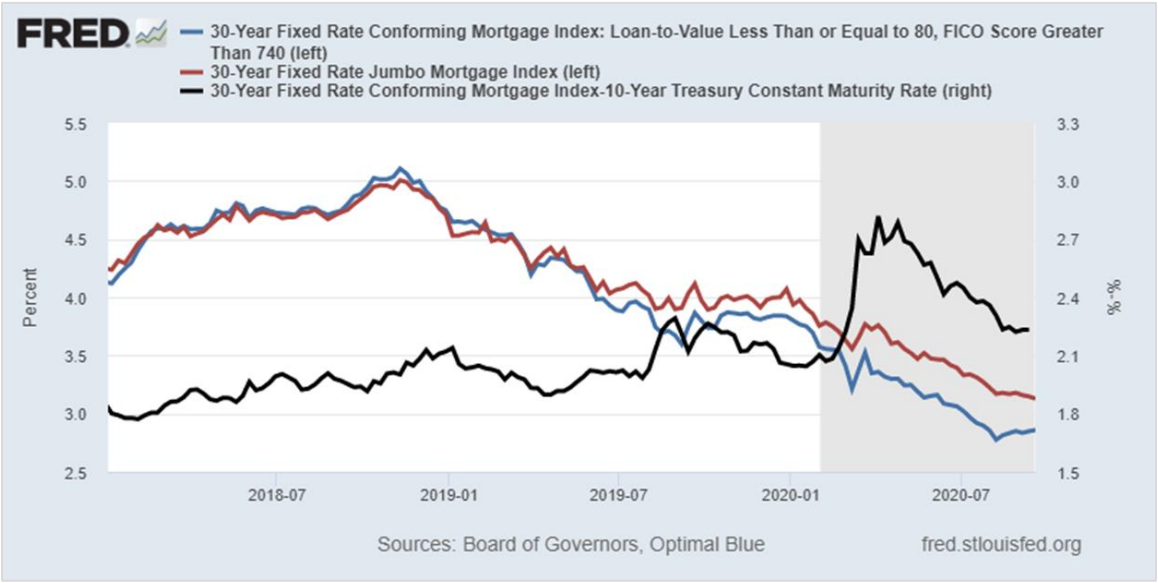
Agency Net Issuance

Issuance Year	GSEs	Ginnie Mae	Total
2011	-$128.40	$149.60	$21.20
2012	-$42.40	$119.10	$76.80
2013	$69.10	$87.90	$157.00
2014	$30.5	$61.6	$92.1
2015	$75.1	$97.3	$172.5
2016	$127.4	$125.8	$253.1
2017	$168.5	$131.3	$299.7
2018	$149.4	$112.0	$261.5
2019	$197.8	$95.7	$293.5
2020 YTD	$353.5	$22.0	$375.4
2020 YTD % Change YOY	328.0%	-61.5%	168.8%
2020 Ann.	$530.2	$32.9	$563.2

Sources: eMBS and Urban Institute.
Note: Dollar amounts are in billions. Data as of August 2020.

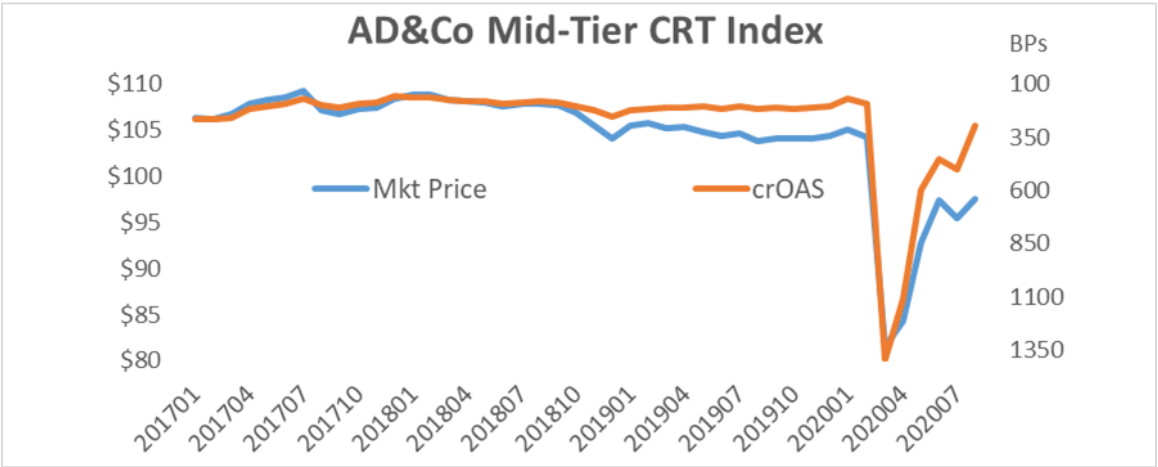
RATES & RISK SPREADS: Mortgage Rate Spread to Treasuries

The 10-year Treasury yield is about 70 bps, in the middle of its trading range since April. The OBMMI™ benchmark 30-year conforming rate continues to gradually tighten from the April wide, but remains about 25 bps wider than before the COVID-19 pandemic. Further, note that jumbo rates were equal to GSE mortgage rates for a few years but have since widened roughly 25 bps—reflecting the strain on depository balance sheets. The widening spread between GSE and jumbo mortgage rates is a sign that cost and access to capital outside of the GSEs, FHA and VA have risen.



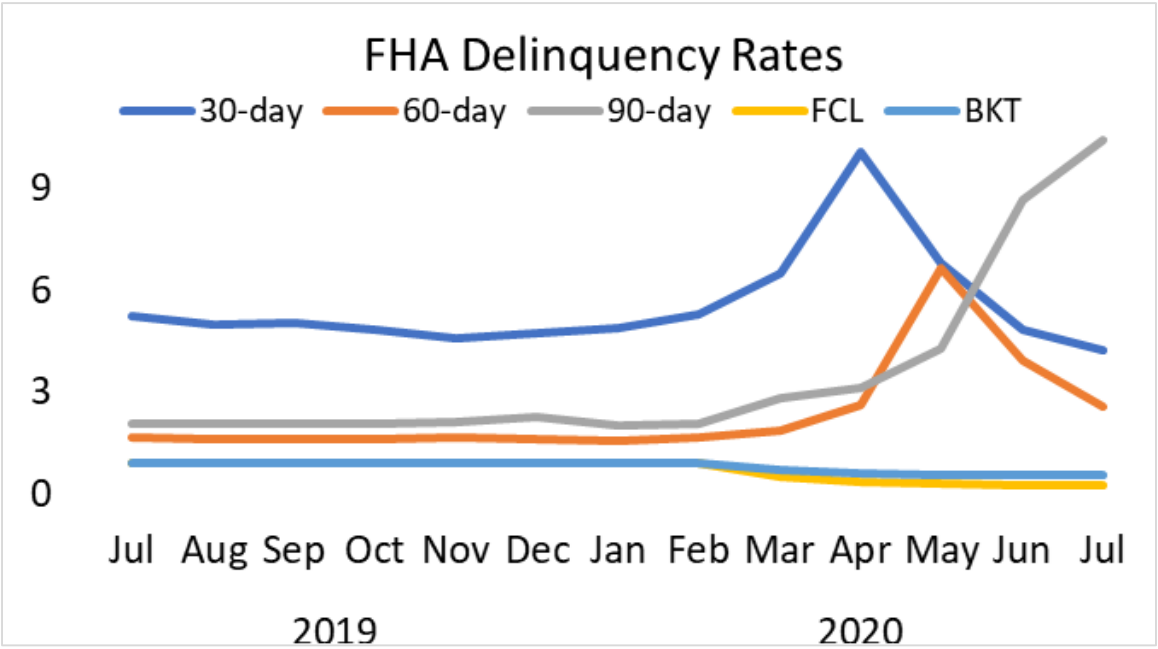
RATES & RISK SPREADS: Mortgage Credit

Aggravating and mitigating factors continue in the housing and mortgage markets. Unemployment is high but housing prices continue to rise, and supply is tight. Mortgage risk spreads have significantly recovered but remain elevated from pre-pandemic levels. Mortgage rates are at record lows and homeowner equity is at record highs. Federal forbearance policy prevents forced selling, and federal stimulus eased the dislocation, although the economy probably needs further stimulus. Financing spreads in the mortgage market have recovered significantly as shown by AD&Co's Mid-Tier CRT Index but remain measurably wider.



The chart below illustrates the changing relationship between mortgage delinquencies and foreclosure for FHA loans. The pandemic-driven surge in delinquencies tracks from April through June in 30-, 60-, and 90-day delinquencies. However, foreclosures nearly ceased. So, will credit losses track delinquencies or foreclosures? Credit losses could be quite low to the degree that:

- Forbearance policy persists through pandemic resolution and economic recovery
- Most FHA borrowers regain employment
- Housing prices continue flat to rising



[a] The 90-day category includes all loans that are at least 3 months delinquent excluding those loans in-foreclosure or in-bankruptcy processing. Included in the delinquency counts are loans under active consideration for loss mitigation foreclosure avoidance

[b] Exceptions are counted separately from delinquencies, regardless of the length of the delinquency period.

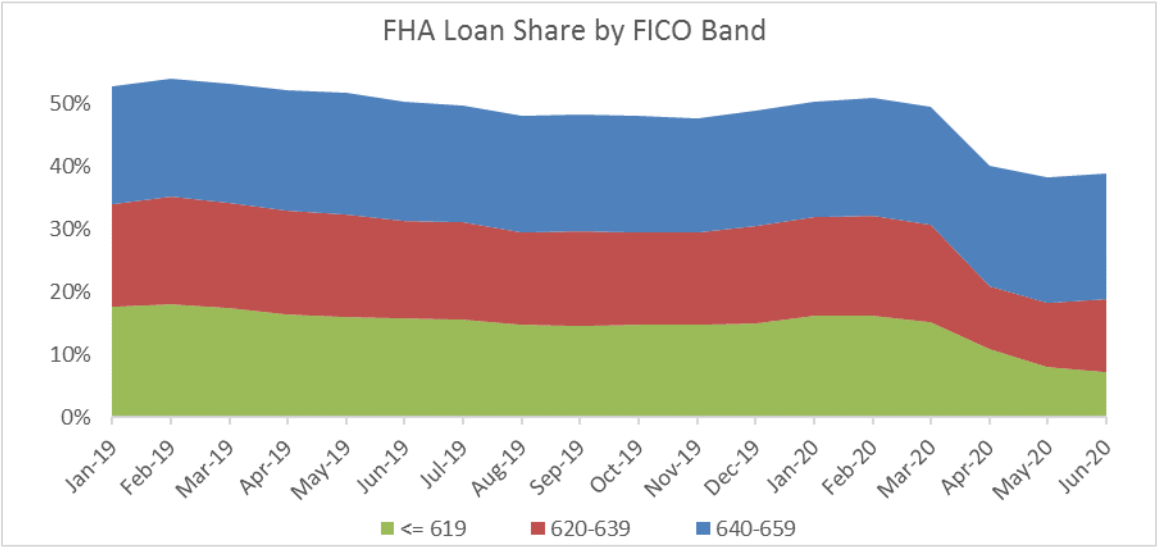
[c] Serious delinquency rates are the sum of 90 day delinquencies and in-bankruptcies.

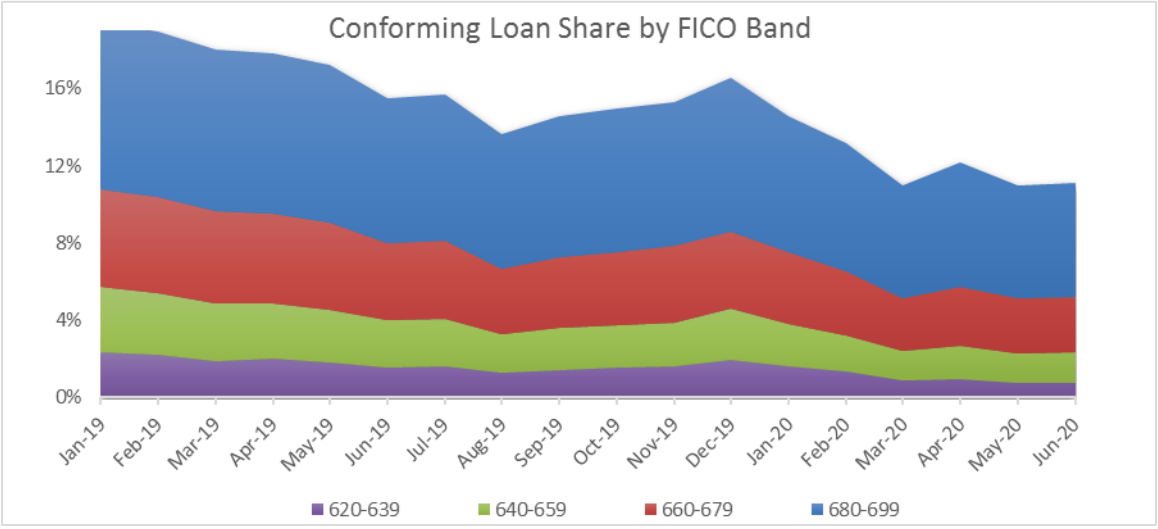
SOURCE: U.S. Department of HUD/FHA, August 2020.

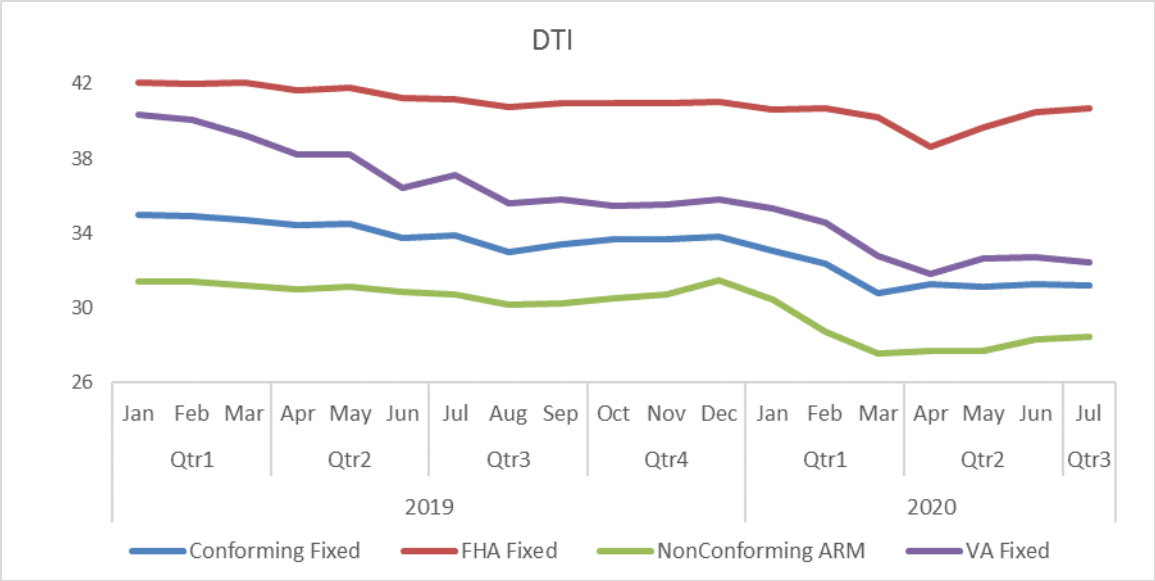
Outcomes should be similar in GSE markets and this simply highlights the credit investors' dilemma. Uncertainty is elevated and policy risk remains though losses could be low. Servicer operating costs are likely to remain elevated until this is all resolved, keeping pressure on earnings, servicing multiples, and financing. LTVs, credit scores and DTIs have all remained tighter than before the COVID-19 pandemic.

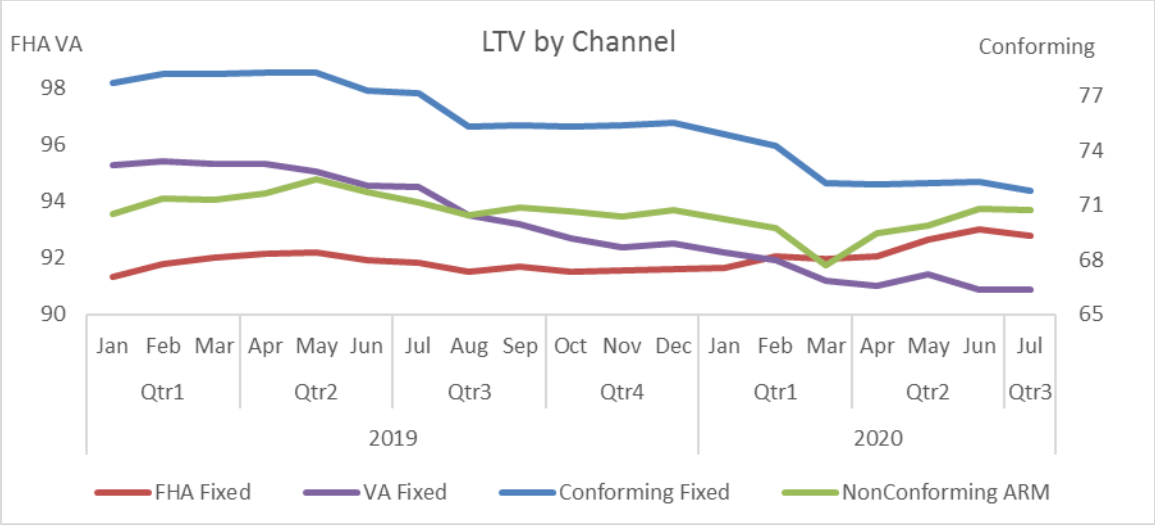
The GSEs, FHA and VA did not tighten underwriting and have not yet raised prices. So, why did the origination market do so? Three leading reasons are: 1.) the collapse in servicing values which is directly correlated to credit risk, 2.) capacity constraints in the market that led to originating the 'easiest' loans, and 3.) delivery uncertainty for closed loans that enter forbearance before security settlement because of delivery charges imposed by the GSEs for loans that go into forbearance while in the pipeline.

The share of lower FICO originations materially fell for FHA and GSE loans. Average LTVs also generally fell except for FHA where they slightly rose. DTIs also generally fell, again except for FHA where they rose.






DTI
42
38
34
30
26
Jan Feb Mar Apr May Jun Jul Aug Sep Oct Nov Dec Jan Feb Mar Apr May Jun Jul
Qtr1 Qtr2 Qtr3 Qtr4 Qtr1 Qtr2 Qtr3
2019 2020
Conforming Fixed
FHA Fixed
NonConforming ARM
VA Fixed


LTV by Channel
FHA VA
Conforming
98
96
94
92
90
77
74
71
68
65
Jan Feb Mar Apr May Jun Jul Aug Sep Oct Nov Dec Jan Feb Mar Apr May Jun Jul
Qtr1 Qtr2 Qtr3 Qtr4 Qtr1 Qtr2 Qtr3
2019 2020
FHA Fixed
VA Fixed
Conforming Fixed
NonConforming ARM

CONCLUSION

Strong tidal flows are pushing the economy in complex directions; the macro-economy and the mortgage market are especially and immediately reactive to Federal policies and interventions. The housing and mortgage markets are strong despite greater economic uncertainty that is reflected by wider risk spreads and reduced credit access for less liquid borrowers and companies. Low rates and remote work have led to homeownership rates that measurably rose this year, including for minority households, reversing a 10-year trend. Economic stress will continue to build while the pandemic's dislocation persists—possibly another year—so timely and effective federal policy responses will remain crucial.