RBC Global Asset Management

Risks in mortgage sectors

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Not all mortgage markets are created equal.

Mortgage markets across the globe have started to feel the effects of higher inflation coupled with tighter global monetary policy. Coming out of a protracted period of mostly benign arrears performance, the next 12-24 months should shine a light on the resilience and structure of these mortgage markets and their corresponding RMBS. Looking at the state of play today, these markets vary greatly in their composition.

In many key jurisdictions mortgage rates are more than double the level at the start of the year. This will clearly have a large impact on the affordability of housing. However, when it comes to existing stock already present in RMBS, the impact is varied:

- Australia has a high variable-rate exposure, at more than 80% of the total loans outstanding in the non-conforming sector, which means changes to interest rates are transmitted relatively swiftly to borrowers, and lenders can pass through rate rises immediately. Australia's high household indebtedness (as seen by OECD statistics below) also increases borrowers' sensitivity to interest rate rises as borrowers are more levered and have less net disposable income to cover the rise in payments.

- In the US, the mortgage market is predominantly fixed rate and experienced a massive refinancing wave during the Covid-19 pandemic, with most of the market now locked in at comparatively low rates (~3%). The 30-year fixed rate mortgage is the standard conforming mortgage product, and as a result, rising interest rates do not have an immediate impact on affordability for an existing borrower and tighter underwriting standards should maintain or improve the quality of borrowers able to get a mortgage on today's higher rates.

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- The UK finds itself at a halfway house – with most of today's market being fixed rate, the rate increases aren't being passed on immediately. However, with the average fixed term being two or five years at origination, the expectation is that circa 100,000 mortgages per month will roll off between now and Q3 2024, by which point ~ 55% of the market will be floating rate or will have refinanced to a higher fixed-rate mortgage.

It is worth noting that we have not seen any significant pick up in arrears across these mortgage markets at this stage, but this is something we are keeping a close eye on. Factors such as a longer monetary tightening cycle, unemployment rises or slowing income growth will all result in a higher arrears outcome for a longer period, and these all depend heavily on the jurisdiction.

	US	UK	Australia
Mortgage market size (USD)	USD 13 trillion	USD ~1.8 trillion	USD ~1.3 trillion
% of market that is fixed rate	~99%	80-85%	35%
% of market which is either floating or where fixed period runs off next 24m	~1%	~55%	~90%
Average length of fixed term	30 years	2-5 years	1-5 years
January 2022 mortgage rate	3%	1.6%	2.2% in August 2021, 3% in January
September 2022 mortgage rate	6%	5%	6%
Household debt as a % of net disposable income 2021 (OECD)	101%	148%	203%
Home price appreciation since January 2020	43.4%	26.0%	16.0%

Source: Bloomberg, S&P, OECD, Urban Institute.

Impact on home valuations

When it comes to US home prices, the month-on-month deceleration seen in July data was the fastest ever seen in the Case-Shiller National Index and the first negative monthly print in over ten years. While the year-on-year number is still at +15.8%, economists are forecasting a quick slowdown given the shifts in the landscape. Both new and existing home sales are showing weakness and we expect this to continue with rates climbing steeply since the start of the year.

In the UK, demand is weakening with mortgage approvals below pre-pandemic levels and forecasted rate rises well documented, and this can only serve to soften home prices from the double-digit year-on-year numbers seen most recently. Australia has already seen house price declines both nationally and even more so in specific cities.

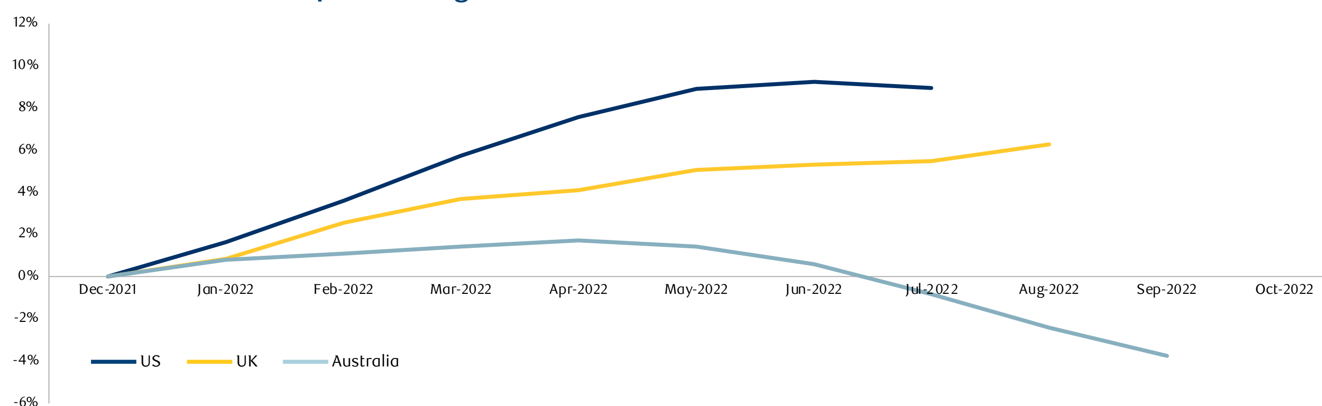
RMBS outlook

In terms of our investment outlook, in the US our focus continues to be on mortgage pools with seasoned collateral where the LTVs adjusted for changes in house prices are materially lower and thus as an investor, we have that additional protection against home price declines (often >35%).

In the UK/Europe, the weakening housing demand outlook coupled with the cost-of-living crisis being more severe has led to us pivoting to holding higher-quality RMBS.

In Australia, our exposure has never been material, and even at current spread levels we do not believe investors are adequately rewarded for the risks. The backdrop of variable rate mortgages coupled with already falling home prices leaves us cautious.

Chart 1: National home price change since 31 December 2021



Source: Bloomberg

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