Some five years after the worst housing market collapse since the Depression, signs of life are emerging in real estate. Led by resurgent multi-family construction, housing starts have risen to a three year high. At the same time, in the existing market, single-family home sales levels have reached levels last seen during the homebuyer tax credit of early 2010. After several years of subtracting from growth, residential investment is finally adding to economic activity.

Nonetheless, amidst the progress, a shadow supply of distressed sales threatens to spoil the party. The recent settlement between state attorneys general and the five largest mortgage servicers will raise the number of distressed sales entering the market over the next year. As legal uncertainties ebb, an increasing number of distressed sales are poised to enter the market over the next year. As the foreclosure floodgates are opened, fears have been raised that a vicious spiral of declining home prices and higher defaults will drown the nascent housing recovery.

Home prices are likely to decline over the next year, but improvements in mortgage quality, alongside renewed efforts at foreclosure mitigation, will mitigate against a vicious spiral. Moreover, as the job market continues to recover, the number of existing home sales is also likely to increase, limiting the extent of price declines as a result of the added distressed supply.

All told, as fewer mortgages enter delinquency, reducing the stock of inventories can be managed without flooding the hous-

### Highlights

- The housing market is showing signs of life. Home sales and housing starts are rising and residential construction is finally adding to economic growth.

- The thorn in the housing recovery’s side is the backlog of foreclosures. As legal uncertainties ebb, an increasing number of distressed sales are poised to enter the market over the next year.

- Clearing the housing market of distressed sales will be a challenge, but the housing market is well positioned to meet it. Improvements in mortgage quality alongside loan modification efforts have reduced the number of seriously delinquent mortgages and job growth will support an increase in housing demand.

- Home prices are expected to decline by around 3.5% in 2012 before beginning a modest recovery in 2013. The turn in home prices will set the stage for a multi-year construction recovery that will be an important contributor to economic growth.

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### U.S. HOME PRICES

- Year-over-year % change

- S&P Case-Shiller*
- CoreLogic Home Price Index
- CoreLogic Excl. Distressed Sales

*Twenty city composite. Source: CoreLogic, S&P Case-Shiller, Haver Analytics
ing market with distressed sales. This should result in price declines that are contained to the low single digits. By 2013, we expect home prices to begin a modest recovery.

**From seriously delinquent mortgage to distressed sale**

The process of moving from delinquency to distressed sale is not a straight line, but rather more akin to a round-about with multiple exits and entry points. While the shadow inventory of seriously delinquent and foreclosed homes is often used as a gauge to the number of distressed sales, a significant number of these mortgages will exit inventory through other means. To assess how far the inventory process has to go we need to consider: how many mortgages will become seriously delinquent; how many will enter and leave foreclosure; and, finally, how many will end in a distressed sale.

**The starting point – serious delinquency**

We begin our journey with mortgages that are seriously delinquent – more than 90 days behind on their payments – which is when a foreclosure can begin. According to the Mortgage Bankers Association (MBA), 3.1% of mortgages were seriously delinquent as of the fourth quarter of 2011. This is high – prior to the housing bust, the percent never rose over 1% – but it is also down from its peak of 5.0% in the first quarter of 2010.

A key reason for the decline in serious delinquent mortgages is increased efforts at loan modification and foreclosure mitigation. Since the beginning of 2009, over two million loan modifications have been made by mortgage servicers either on their own or through the Home Affordable Mortgage Program (HAMP).

Unfortunately, loan modifications do not always result in a mortgage permanently leaving the serious delinquent pool. Roughly 30% of the mortgages that have undergone HAMP modifications have ended up back in delinquency 18 months after receiving the modification. Fortunately, re-default rates have fallen with newer vintages of modifications, showing an increased effectiveness of modifications in reducing foreclosures (see chart bottom left).

Just as important a factor behind the reduction in seriously delinquent mortgages is a decline in the number of households falling behind on their payments and in the number of mortgages moving from lesser stages of delinquency into seriously delinquent status. After reaching a
peak in 2009, the percent of 30-60 day delinquent mortgages transitioning to seriously delinquent has fallen considerably. Alongside this decline, there has been an increase in the number of delinquent mortgages that return to making payments, which has had the net effect of reducing the pool of seriously delinquent mortgages.

There is still room for improvement in terms of transition rates relative to their levels prior to the housing bust, but mortgage quality is more likely to improve than deteriorate over the next few years. Several years of tightening lending standards have resulted in much lower rates of delinquency among newer mortgage vintages. Over 6% of the mortgages initiated in 2006 and 2007 were in delinquency two years after origination, but only 1.6% of mortgages initiated in 2009 were delinquent. Mortgages initiated in 2010 and 2011 are of higher quality, with lower delinquency rates two years out than earlier vintages (see chart below).

All told, as the job market improves, the number of mortgages entering serious delinquency should continue to decline. Mortgage modifications, which have fallen in the last year, are likely to increase in the aftermath of the mortgage settlement. With these trends in place, based on our forecast for employment growth and the unemployment rate, we expect the percent of mortgages that are seriously delinquent to fall from 3.6% to 2.7% by the end of 2012 and further to 1.8% by the end of 2013.

**How many foreclosures?**

The stock of seriously delinquent mortgages has declined over the past year, but the same cannot be said for the in-
inventory of foreclosures. According to MBA, 4.4% of all mortgages were in some stage of the foreclosure process in the fourth quarter of 2011, down only slightly from a peak of 4.6% in the fourth quarter of 2010.

Reducing the stock of foreclosures requires increasing the flow of mortgages out of foreclosure relative to the flow of mortgages in. Over the course of the whole year, 4.1% of mortgages entered foreclosure, down from 5.0% in 2010. Since there was no upward movement in inventories, this implies that an equal number of mortgages exited foreclosure – some of them moving back into delinquency or loan modification and some of them ending in distressed sale.

Due to legal backlog and foreclosure moratoria in several states, foreclosures have been delayed at all stages of the process. In the aftermath of the mortgage settlement, the number of mortgages transitioning into foreclosure is likely to rise (see chart above). Fortunately, the improvement that has taken place in mortgage quality over the last years means that the increase in foreclosures is likely to be small. And, as long as the broader economic recovery remains in place, the improvement in seriously delinquent mortgages will begin to reduce the number of foreclosure starts in the relatively near future. By 2013, foreclosure starts should begin to move steadily downward.

How many distressed sales?

With the number of mortgages entering foreclosure likely to remain elevated – at least in the near term – this leaves the task of reducing foreclosure inventories to rising foreclosure liquidation (and therefore distressed sales). The flow of distressed sales will depend on how fast foreclosures can move through the judicial system as well as how fast mortgage servicers are able to bring sales to market. It is difficult to pinpoint how fast this will occur in a single year.

As a baseline, reducing the stock of foreclosure inventories to their pre-2006 level by the end of 2013 would require a 30% increase in the number of distressed sales. As long as mortgage quality continues to improve, the rise in distressed sales will likely crest over the course of 2012, before gradually declining in 2013.

If judicial backlogs reduce the pace of foreclosure liquidation, foreclosure inventories will take longer to decline, but the flow of distressed sales over the next year would be smaller. Given that the highest inventories are concentrated in states with judicial backlogs, a 30% increase in distressed sales is likely a best-case scenario in terms of reducing foreclosure inventories (and worst-case scenario in terms of the number of distressed sales in 2012).

Bottom Line

In all likelihood, distressed sales will rise over the next year. This will have a dampening effect on home prices, but given improvements in the mortgage pipeline, it is unlikely to lead to a vicious spiral. On the contrary, clearing the market of foreclosure inventory is a necessary precursor to a stronger housing recovery. As foreclosure inventories are drawn down, the improvement in financial conditions is more likely to lead to a virtuous cycle of improving credit availability and even greater mortgage demand.

The supply of distressed sales is only one side of the equation in determining home prices. Demand for housing is just as important. Fortunately, existing home sales are
turning a corner and are likely to build on the gains seen over the last several months. Recent gains in home sales have been driven in large part by investor demand. According to the National Association of Realtors, 25% of the existing homes sold in January were investor sales and 31% were cash sales. However, while investors have been instrumental in kicking off the recovery and continue to play a role in clearing the market, a sustained recovery in housing will require more active participation among first-time homebuyers and move-up buyers. Fortunately, after several years of declines there is considerable pent-up demand among these buyers. With mortgage affordability at record highs and job growth accelerating, we expect home sales to rise by about 15% over the next year, absorbing much of the increase in distressed sales.

All told, as the final surge of foreclosures make their way onto the market, home prices (as measured by the S&P Case-Shiller home price index) will likely decline by around 3.5% in 2012. However, short-term pain is the price of long-term gain. By 2013, with foreclosure inventories falling, home prices are likely to increase in line with overall inflation. With this roadblock cleared, a sustained gain in residential construction is likely to begin.

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