



WEEKLY ECONOMIC COMMENTARY

- **Countries should be careful not to overstimulate their housing markets**
- **Credit extension is improving, but remains modest**

Because I will be overseas this coming Sunday, I invested quite a bit of time last weekend doing my Mother’s Day assignments in advance. Flowers were planted, meals were prepared, and bushels of laundry were washed. I also painted the pedestal on which my wife rightfully stands.

As I was standing in line at the home improvement store preparing for these labors, a fellow looked at my overladen cart and said, “Ahh, the joys of home ownership.” He meant it ironically. But at a macro level, many countries pursue the joy of home ownership as a matter of policy.

With governments and central banks around the world searching for avenues toward better economic growth, residential investment is a common target. It responds reliably to interest rates and to programs which broaden access to credit. It is relatively easy to account for and resonates with the public, and therefore makes good headlines.

Thanks to a range of stimulus measures, house prices are advancing once again in many major markets. Yet housing has a dark side. Property has historically been an object of excess, and the corrections that inevitably follow harm communities both financially and socially. While the current housing recovery has been gratifying, it nonetheless raises worry over whether we’re getting too much, too soon.

Housing does not account for the lion’s share of gross domestic product (GDP). But it is a powerful driver of swings in GDP, and its legs can be long; the carryover spending on maintenance and improvement can be substantial through the years. Further, studies have shown that greater home ownership is associated with better educational outcomes, lower rates of crime and other positives.

To reap these rewards, governments have maintained tax preferences and broadened access to credit for housing. These measures have increased residential owner-occupancy steadily over the last several decades.

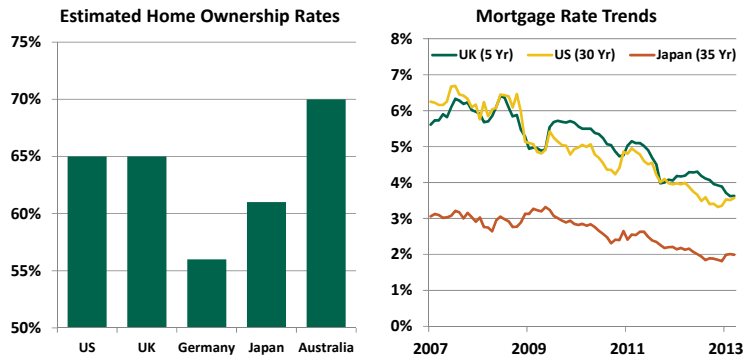
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**Once warmed, housing markets are prone to overheating.**



Source: National Bureaus of Statistics, Bloomberg

Differences in home ownership rates across countries are created by a number of demographic and financial factors. But the dream of having property is very much an international one.

Since the Great Recession, though, home ownership has declined sharply in a number of major markets. Among the efforts aimed at reversing this trend has been quantitative easing, which has

**Despite their growing profits, the GSEs should not be allowed to remain in their current form.**

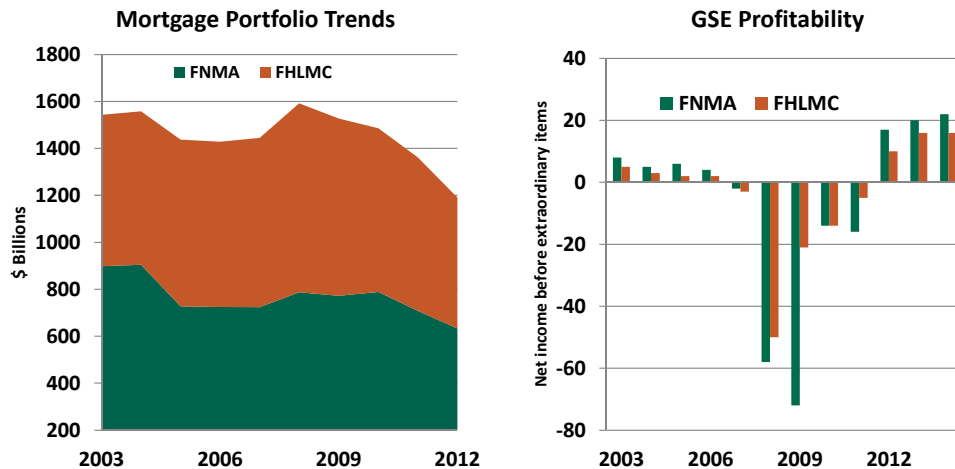
brought mortgage rates down significantly over the last four years. In the United States, the Federal Reserve's efforts have created a bit of frenzy during the traditional spring selling season; bidding wars have returned, and lots long vacant are being developed at breakneck speed.

All signals suggest that the use of home mortgage credit has not gotten out of hand. Financial institutions remain cautious in this area, requiring much higher down payments than was the norm seven years ago. A range of new regulations has curbed aggressive underwriting practices.

But there is certainly some temptation in many markets to add fuel to the housing fire by easing lending conditions. Yet the stories of two key institutions that facilitated the housing boom in the United States and supplied securities to investors the world over provide a cautionary tale.

The U.S. Government Sponsored Enterprises (GSEs) Freddie Mac and Fannie Mae remain under government conservatorship, awaiting word on their futures. These companies became global brands, creating the second-largest fixed-income market in the world. To achieve this end, they performed three roles. They set standards for loans and bonds that made them easy to bundle and sell. They offered insurance against homeowner default to those who purchased mortgage-backed securities. And they used their balance sheets to maintain liquidity in the market.

In retrospect, mistakes were made in each of these areas. The press to make mortgages easy to sell led to the problems experienced by Mortgage Electronic Record Service (MERS), which lost track of key documentation. Mortgage insurance offered by the GSEs was, as we now know, underpriced. And Freddie and Fannie ultimately got high on their own supply, owning huge portfolios of their own originations which are now being worked down.



Source: FHFA, Bloomberg

Further, the GSEs were used to advance several social objectives, including the promotion of affordable housing. Whatever the merits of this policy, it ultimately created a conflict with the overarching goal of sound loan underwriting. Freddie and Fannie ultimately ended up owning or insuring a substantial volume of mortgage securities, losses on which have required almost \$200 billion in government support.

GSE reform has been slow in coming. Discussions center on which of the three core functions should remain with Freddie and Fannie, and which should be separated and done privately. In the meantime, the agencies have become wildly profitable. Fannie Mae announced this week that it

**Bank lending growth has been improving, but it has been very uneven.**

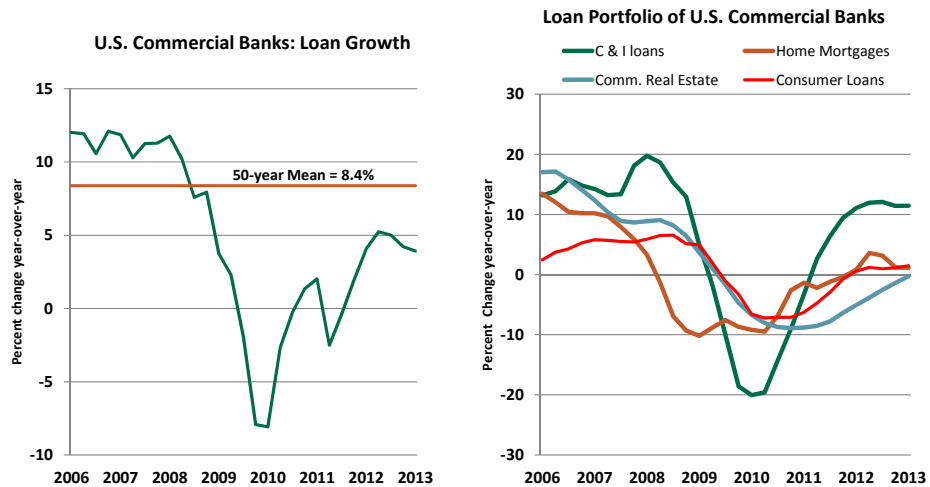
would be remitting \$59 billion of its recovered lucre to the U.S. Treasury. The addiction of the Federal government to this profit may dull the edge of the reform movement.

The stories of Freddie Mac and Fannie Mae should give pause to global policy-makers who seek to add strength to their housing sectors. Short-term gain can yield to longer-term pain. Certainly, it is not reckless to hope that home prices recover. But it would be highly desirable if they recovered in a stable and sustainable fashion, supported by sound underlying fundamentals as opposed to excessive government support or fleeting levels of leverage.

In the meantime, I'll continue to boost the value of my home the old-fashioned way: by investing sweat equity.

### Interpreting Recent Lending Trends

The Fed is keeping a close watch on the impact of its asset purchases, including lending trends in the economy. At one level, the Fed's actions affect levels of reserves in circulation and market interest rates. This is often referred to as the interest rate channel. At a second level, the credit channel funnels new reserves into bank loans, adding to the pace of business activity. Lending trends are an important indicator of the reach of monetary policy.



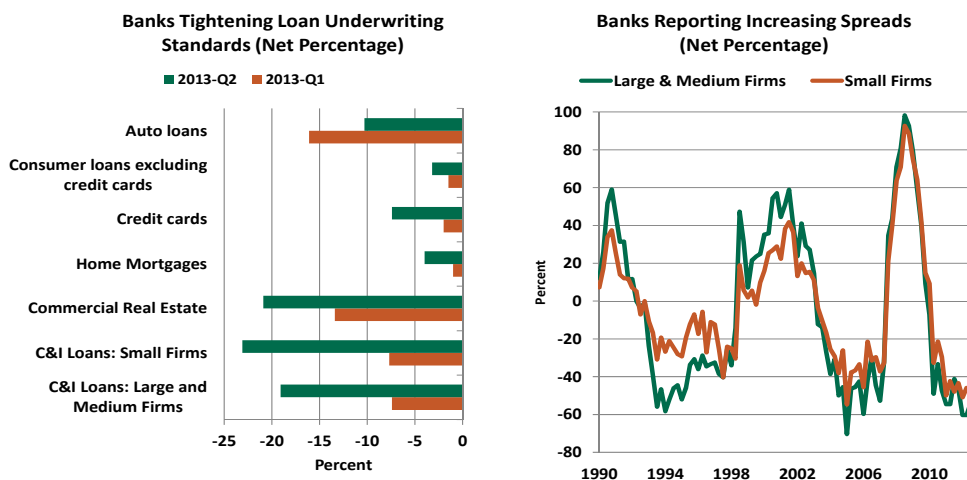
Source: Federal Reserve Board/Haver Analytics

Moving from economic theory to evidence about bank lending following the Fed's aggressive monetary policy easing programs, bank lending shut down in 2009 and turned the corner only in early 2010. Bank lending dived from a peak of \$9.5 trillion in October 2008 to \$8.9 trillion in February 2010. At the close of the first quarter of 2013, it stood at nearly \$10 trillion, higher than the pre-crisis peak.

Bank lending rose 3.9% from a year ago in the first quarter of 2013, after advancing 4.2% in the fourth quarter of 2012. The loan portfolio of commercial banks shows that commercial and industrial loans have been the fastest-growing component, although momentum flattened in the first quarter. Home mortgage lending and loans for commercial real estate remain soft, with the former showing a marginally better trend.

The main takeaway is that growth in bank lending following the Fed's quantitative easing programs has yet to match the 8.4% historical mean, implying that there is room for growth without concerns about a worrisome escalation of bank lending.

The latest Senior Loan Officer Survey results indicate that banks eased lending standards for commercial and industrial loans, residential mortgages, commercial real estate loans and consumer loans in the April 2013 survey compared with the previous round. This is a noteworthy change because tight credit has been cited as one of the reasons for moderate growth. Essentially, the recent survey results suggest that it should not be surprising to see additional growth in bank lending in the near term, given the easing of loan underwriting standards.

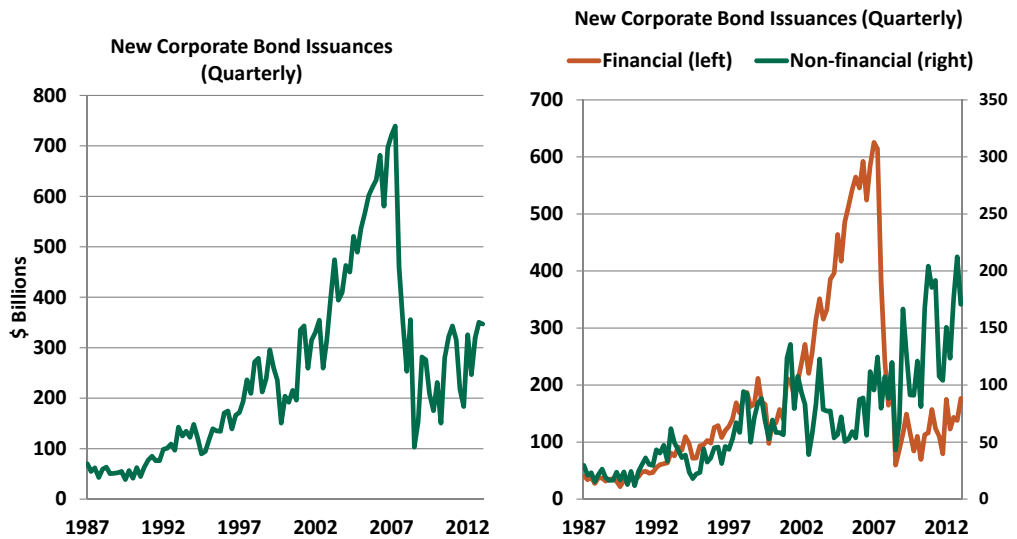


Source: Federal Reserve Board/Haver Analytics

However, a large number of banks are reporting narrowing in spreads, which leaves them vulnerable to margin pressure. On the bright side, the cash position of banks relative to their assets is significantly high (14% versus 20-year mean of 6.2%) and suggests that banks have a comfortable cash cushion.

Outside of the traditional banking sector, credit raised through new bonds is another part of private sector lending. Corporate bond issuance by industry paints an interesting picture. Bond issuances in the non-financial sector have scaled new levels, with total new issuances in 2012 at \$663 billion, a record high. If this year's first quarter trend of non-financial corporate bond issuance (\$171 billion) is maintained, a new record is certain for 2013. Bond issuances in the financial sector amounted to \$579 billion in 2012, the smallest since 2000. The first quarter reading (\$176 billion) places the outlook for 2013 close to that of 2012.

Corporate bond issuance in the non-financial sector is likely to set a new record



Source: Federal Reserve Board, Haver Analytics

Putting together lending trends from the banking and bond sectors, the main conclusion is that credit trends are picking up steam, but more will be necessary to establish a fully functioning credit operation that is consistent with self-sustained economic growth.