

What Fed Moves Mean for Mortgage Rates

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By Luke Mullins

Faced with a weak dollar and rising inflation, the Federal Reserve seems done with its aggressive rate-cutting campaign. Here's how this shift in monetary policy may affect mortgage rates this year:

ADVERTISEMENT **How have fixed mortgage rates been moving recently?** They've climbed. The average 30-year, fixed-rate conforming mortgage increased from 5.91 percent for the week ending March 21 to 6.11 percent for the week ending April 25, according to HSH Associates, but it's still on the low side by historic standards.

How will the rates change over the next several months? With several factors pushing interest rates higher--and not much pulling them lower--fixed mortgage rates are likely to increase modestly in the coming months. "They are right around 6 percent now, [and] they are probably going to stay there the first half of this year," says Gus Faucher, the director of macroeconomics at Moody's Economy.com. "Then they are going to gradually move higher in the second half of this year."

Is that because of what the Fed is doing? No. This upward trend has little to do with monetary policy. The federal funds target rate--the Fed-controlled interest rate that banks charge one another for overnight loans--plays only an indirect role in setting mortgage rates. Instead, the rates are being driven higher by recent developments affecting the yield on 10-year treasury notes, which influences mortgage rates more directly.

What's happening with the 10-year treasury yield? It has been on an upswing. With fear reaching teeth-chattering levels in the days after the Bear Stearns investment bank came close to collapse in mid-March, the yield on the 10-year treasury--where investors head for safety during times of turmoil--fell to near-historic lows. But after the Fed cut interest rates and created innovative new ways to get cash to banks, the market staged a turnaround. Yields climbed nearly 17 percent, to 3.87 percent, from March 17 to April 25.

So, what's driving the yield higher? There are two key reasons behind this about-face:

--**Risk looks better.** Some market participants think they see an end to the credit crisis. "The worst is behind us," Lehman Brothers CEO Richard Fuld recently told shareholders, according to Bloomberg. With credit markets on the mend, those safe but low-yielding treasuries suddenly don't look so appealing. Investors are "pulling money out of the safest places in order to put them back to work in perhaps somewhat more risky assets," says Keith Gumbinger, vice president of HSH Associates. Less demand for treasuries means lower prices and higher yields.

--**Angst about inflation.** Rising concerns over inflation are also pushing 10-year treasury yields higher. For example, in early April, the government reported that the cost of imported goods jumped nearly 15 percent in March from the same month last year. "The data only goes back to 1983, [but] we've never see inflation this high," says T. J. Marta, a fixed-income strategist at RBC Capital Markets. With inflation worries increasing, bond investors are demanding a higher return on their money at risk. "You see the yields start to rise fairly sharply because now people are focused on inflation," Marta says.

Is there anything that might help moderate this increase? There is. Not all of this increase will be passed on to consumers in the form of higher mortgage rates. Typically, rates on a 30-year fixed mortgage are about 1½ percentage points higher than the yield on the 10-year treasury. But after the housing crisis hammered their portfolios, lenders and investors have grown wary of mortgages and are demanding higher returns. As a result, the difference between the 30-year fixed-rate mortgage and the 10-year treasury yield--known as the risk

premium--has ballooned about 50 percent, to 2.32 percentage points, over the past year, according to HSH Associates.

But with lenders having tightened underwriting standards--making mortgages safer investments?--these risk premiums could narrow, Gumbinger says. "If underlying interest rates do rise, my suspicion is that there won't necessarily be a corresponding increase in mortgage rates," he says. "They will probably be influenced to some degree, but there is an awful lot of spread which could be compressed." So while higher 10-year treasury yields will put upward pressure on fixed mortgage rates, some of that increase will be absorbed by narrowing risk premiums--helping moderate the rise.

What's the outlook for adjustable-rate mortgages? Adjustable mortgage rates will face similar upward pressure from rising treasury yields. The conforming 5/1 adjustable-rate mortgage--which offers a fixed interest rate for the first five years and then adjusts annually for the remaining 25--stood at an average of 5.89 percent for the week ending April 25, down from 6.08 percent a year earlier, according to HSH Associates. "By the end of the year, we might be working toward around 6.25 percent," says Mike Larson, a real estate analyst at Weiss Research.

Has the Fed's rate-cutting campaign helped struggling adjustable-rate-mortgage holders who may be facing foreclosure? Yes, but you might not see it. Although adjustable-rate mortgages are more closely linked to the federal funds rate than fixed-rate home loans are, they have fallen only about half a percentage point since September, despite the Fed's aggressive series of rate cuts. That's because exotic mortgage products have played a key role in the foreclosure crisis, making them radioactive to investors. When investors aren't eager to buy these loans, rates must increase to attract buyers. As a result, adjustable-rate mortgage holders have not seen their monthly payments decrease a great deal.

But that doesn't mean the Fed's actions have not helped borrowers who have ARMs, says Faucher of Moody's Economy.com. "The truth is that if [the Fed] hadn't cut [the federal funds rate], adjustable rates would be even higher...and the problems would be much more severe," Faucher says. "So you can't just say, 'Well, the Fed hasn't done anything.'"