What Moves Mortgage Rates

What Affects Mortgage Rates?
(Tools to help you know when to lock in your rate)

What makes mortgage rates rise or fall? Is it the Fed, the economy, inflation, the banks, the President, Fannie Mae or Freddie Mac?

Rates are affected by a number of factors including the following:

- Loan default
- Early loan payoff
- Loan fraud
- Foreclosures
- Lender margins
- Inflation
- Economic news (and even expected economic data)
- Mortgage backed securities market (supply and demand)
- The Fed does not directly move long-term mortgage interest rates

In the former days of mortgages, lenders collected money from investors in the community and paid interest to the investors for borrowing that money. These banks held on to their own loans and therefore could only lend out money they personally held in deposits. To be able to free up cash and lend to more people, lenders started selling their loans to other investors so that they could use their available funds to make more loans. To sum it up, most mortgage lenders lend money, sell the loan to investors, and then they have more money to lend. Most mortgage money to buy these loans comes from investors through what is collectively known as the 'capital markets.' This is where investors interested in purchasing certain kinds of debt instruments come to buy these items. Once an agency purchases a mortgage, it is grouped with many other mortgages and is sold on the securities market as mortgage-backed-securities. In order to attract investors to buy these mortgaged-backed-securities (MBS), the MBS must be attractive to the investors.

The investors can purchase many types of investments which are reasonably similar in performance, such as US Treasuries, corporate bonds, foreign bonds, and others. Who are these investors, and why are they so picky? Mostly, they're people like you and me who want high returns on their investments. You (or your investment advisor or fund manager) will not buy low- yielding bonds (mortgage or otherwise), because you'll take your money elsewhere if your returns are too low. Investor demands for a given kind of investment plays a considerable role in moving market yields, because investors have literally hundreds of places to put their money. It's a simple supply and demand situation with many sellers of various products competing for those investor dollars. So rates on mortgages are largely affected by the demand of the investors who will eventually purchase those mortgages and the demand of the investor is determined by the performance of their investments. That is why foreclosure, early loan payoff, loan fraud, etc. make a huge impact on mortgage rates. Basically, if the investment holds mortgages that they cannot collect the interest on, then that loss is passed on to the investor. In the case of foreclosure, foreclosure occurs when a borrower can't pay back the loan on a home and thus the lender seizes the property and tries to sell it to recover the loan amount. If the home doesn't sell for high enough then the portfolio loses money. To bring it home, if you or your neighbors do not pay your mortgages on time, you can expect rates on mortgage to increase.

How are 10-year T-Bonds related to mortgage rates?
Mortgages are priced for sale to attract investors who seek fixed income investments. The competition for the investor's money is all the other options in the bond market. So, the mortgage rates (yields) rise and fall with those competing investments to a greater or lesser degree. Fixed mortgage rates, like other bonds, track US Treasury bonds quite well. Since Treasury obligations are backed by the 'full faith and credit' of the United States, they are the benchmark for many other bonds.

When you hear or see bond prices displayed, make sure you understand that bonds have both a price and a yield, and they move opposite of each other. So, when you hear that 'the bond market rallied today' or that 'bonds closed up 2/32nds today', that means that the **price** of the bonds went up, so the **yield** went down. A decrease in the yield is good news for mortgage rates. Professional money managers constantly strive to obtain high-yielding instruments at a given level of risk and thus money shuffles from place to place (or from a US Treasury to a MBS and visa versa) in search of the highest paying yield. Although the relationship isn't a fixed one, mortgage rates follow similar patterns as the **YIELD** of the 10-year US Treasury.

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Being backed by the government means that Treasury obligations will be paid by the government and since the government can always create more money to pay those debts, the risk level is almost zero. If you are the investor, would you rather buy a US Treasury with little or NO risk or a mortgage-backed-security WITH risk? The answer is it depends on the rate (yield). If you are paid a higher rate of return on the MBS then it would make sense to buy the MBS when the risk behind it matches the return on the investment. But how much higher are mortgages priced? The markup or 'spread' above the secure Treasury expands and contracts with a range of market conditions, investor appetites and supply of available product s, as well as other competing investment opportunities. This is why economic information can change mortgage rates since it affects the risk associated with that investment. If it is reported that the unemployment rate has increased or is expected to increase, the odds are that many of the mortgages held in the MBS have homeowners who will be among those who lost jobs which could result in a higher default rate. A higher default rate means the MBS will perform worse than expected and the yield required by the investor will rise to meet the added risk, and mortgage rates go up.

Then, there's the unknown supply stream, also known as 'volume'. Unlike many other investment opportunities, no one really knows how many mortgages will be originated, and then made available for sale (as bonds) in a given period of time. For example, a quick drop in interest rates pushes many homeowners to refinance and thus may produce a large buildup of loans to be sold to investors. Such an event creates too much bond supply and investors simply cannot absorb it all at once. Going back to supply and demand, too much supply and not enough demand means prices have to go down, and yields (or rates) have to go up to attract investors.

All these factors take time from when they occur to when the affect is physically seen in the change of mortgage rates. Though shorter than in past years, it takes anywhere from several hours to several days for increases or decreases to get from capital markets to where loan originators like National Home Mortgage are working with you. Sometimes, a minor increase in bond yields in the morning is followed by a minor decrease in the afternoon and so mortgage rates may remain the same all day. Other times, rates can change several times in any given day.

The other risk that can change the rate is the lock-in period. To 'lock-in' a loan, the borrower is guaranteed that the interest rate will not change as long as the loan funds before the lock in period ends. It is a way of hedging risk. Once the rate is locked in, despite what the mortgage market does from that time forward, the borrower's rate is unchanged. So, the longer the rate lock period, the more risk is placed on the lender and thus your rate will increase to match that risk. For example, if you lock in your rate at 6% and the very next day the investors are only purchasing that type of mortgage at 6.5%, then the lender will have to sell the loan at a discount since the investor requires .5% more from that investment then what you will actually pay over the life of the loan. Most rates are quoted with a 30-day lock already put into the price, but technically any lock-in period longer than 12 days has an additional price added in to your rate.

There's also the impact of inflation, which affects all investments. Rising inflation reduces the actual return on a fixed interest rate investment. For example, with 2% inflation, that 6% mortgage note returns only 4% 'real' interest. If inflation is expected to decline for the foreseeable future, you can bet that mortgage rates will fall accordingly. Conversely, an outlook which suggests higher inflation ahead will see mortgage rates rise, sometimes very quickly.

The Fed's Role (Federal Reserve)
Fed moves have no direct affect on long-term fixed rate mortgage pricing, but its action or inaction (and expectations thereof) can indeed have indirect affects. To make the complex lending structure easier to understand, basically, each day the banks add up all the money they owe and all the money they have. They then figure out whether they need money to meet their cash reserve requirements or whether they can let other banks borrow from their surplus. The banks that need money get it from the fed or from the banks that have extra money in the form of very short-term loans. That constant process of lending extra cash provides the liquidity that funds the global economy. The Federal Reserve, the European Central Bank and other central banks around the world help pump money into the system to increase liquidity. The Fed can control the discount rate which is the interest rate that the Fed charges to make direct loans to banks. The Fed can also set the 'target' rate for the federal funds rate which is the overnight interest rate which banks charge each other when a bank needs to borrow money to meet end-of-day reserve requirements. It is called the target rate because the actual rate is negotiated between the borrower bank and the lender bank. The rate changes to the discount and fed funds rate can change short-term mortgage rates like home equity lines of credit and adjustable rate mortgages. To realize that

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the Fed does not directly control long-term mortgage rates, it should be understood that the Fed can only control very short term, literally overnight loans, whereas fixed mortgage rates are 30-year terms and are affected by the market. The Fed's actions help control monetary supply, inflation expectations and many other factors that can lead to mortgage rate changes due to changes in the mortgage supply and demand market as discussed earlier. In some ways, expectations of what the Fed might do can be more important than what the Fed actually does, as their actions or inactions can help to confirm or deny what investors believe. Since the mortgage rates generally rise when the economy is improving and fall when the economy is receding, the Fed changes can affect the mortgage rates in different directions depending on how the changes affect the economy, but the Fed raising and lowering 'rates' does not mean mortgage rates are doing the same thing.

So what moves mortgage rates? The economy, the expectations of the economy, supply and demand of the bond market, inflation, and how you and your neighbors pay your mortgages on your personal homes all have a factor in where the mortgage rates will be tomorrow. When locking in your loan, you should work with a professional mortgage consultant who can help you understand the current market and the risk and reward behind when you should lock in your rate. We at National Home Mortgage are always here to help with this crucial part of any loan process. We look forward to working with you soon!