What Will The Fed Do to Mortgage Rates?

What will the Fed do to **mortgage rates?** This is actually a bit of a **trick question**. The Fed doesn't set mortgage rates. The Fed's policy rate applies to overnight loans between large financial institutions. The only way it directly influences mortgage rates is by serving as the basis for the PRIME rate. Home equity lines of credit (HELOCs) are often based on the Prime Rate.

For all other mortgage rates, charting a connection to the Fed Funds Rate is **significantly** more challenging. Indeed, there are many examples of mortgage rates moving in the opposite direction. In other words, mortgage rates have often fallen after a Fed rate hike and vice versa.

But the Fed Funds rate isn't the only aspect of Fed policy. It's in those other policy tools that we find **much** better correlation between Fed actions and movement in the bond market (which ultimately dictates mortgage rate movement). Specifically, the Fed's bond buying programs have been had a bigger impact than anything. When markets expect the Fed to start or maintain bond buying, rates fall significantly. When the Fed threatens to remove or decrease bond buying, rates move higher.

It's worth noting that the Fed is currently buying a ton of bonds--both Treasuries and Mortgage-Backed-Securities (MBS... the ones that directly benefit the mortgage market). There is some small chance that the Fed will announce a change to its bond buying program tomorrow, and likely not for the worse. In a perfect world with no other motivations to consider, such a change would push mortgage rates **even lower**, but the world is not perfect.

In fact, the entire question of the Fed vs mortgage rates is a trick right now because the mortgage market has **far bigger concerns.** For instance, the average lender moved significantly higher in rate today as the previously delayed Adverse Market Fee was re-implemented. It was the biggest day-over-day increase in rates since the initial announcement of the fee. Read more on this HERE. There's very little the Fed could do or say tomorrow to have nearly as big of an impact--at least not in a single day. The silver lining for homebuyers is that the fee only officially applies to refinance mortgages. As such, home buyers will find top tier rates that are still below 3% today whereas the average lender is back above 3% for refinances.

Adverse market fee aside, the Fed would still have a hard time pushing rates significantly lower in the short term simply because the average lender is **already** so incredibly busy. The bond market may open the door for lenders to drop rates, but that only helps if lenders can handle the news business that lower rates would bring.

Lender capacity issues will **eventually** subside and when they do, we will see mortgage rates that are **more willing** to follow the guidance of the bond market--at least until the next time they drop enough to cause another surge in business.

How low would they need to go for such a surge? Or perhaps the better question is how low **COULD** rates theoretically be under ideal circumstances?

Because mortgage rates are based on the bond market, they are really **only limited** by how low certain bond yields can go. Although the 10yr Treasury yield doesn't actually dictate mortgage rates, it's a popular benchmark and easier to understand compared to mortgage bond yields. The 10yr has historically been lower than average 30yr fixed mortgage rates by 1-3% with most of the post-mortgage-meltdown era seeing 1.5-2.0%.

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With 10yr yields capable of all-time lows just over 0.3%, this implies a theoretical lower bound of at least 1.3% for mortgage rates. This is **exceptionally theoretical**, however. Mortgage rates have a tendency to stretch the upper boundary of that range when rates are at all-time lows. For instance, 30yr fixed rates never made it lower than **2.75%**, and when they bottomed out, 10yr Treasury yields were around 0.50%. That's a **2.25% spread** between the two! Treasury yields would need to remain at or under 0.50% for years in order for that spread to get as small as past precedent suggests it can be.

Beyond this simple comparison with Treasury yields, the mortgage market also has to consider the structure of its own bonds. Specifically, investors need to be actively trading mortgage bonds that don't yet exist in order for rates to get appreciably lower than 2.25%. They usually wait to do so until the bond market leaves them no other choice. The bottom line is as follows. While rates could indeed move lower in the future, the improvements will be harder and harder to come buy as we approach the low 2% range. Moving any lower from there would take a significant amount of **time**.