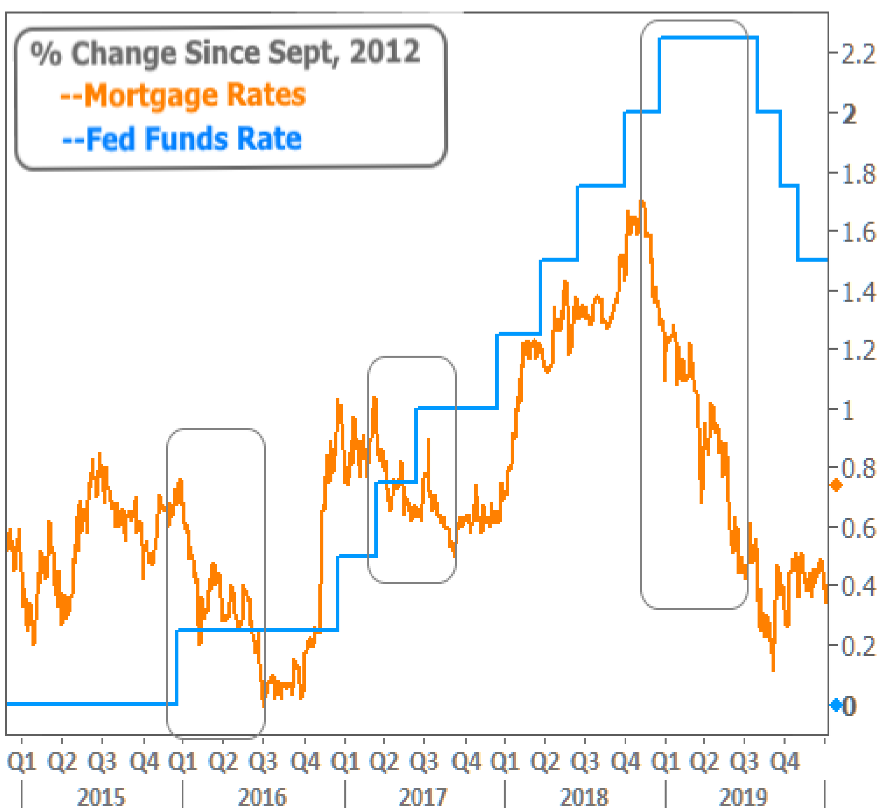
HOUSING NEWSLETTER

The Week's Most Important Housing News

Highest Mortgage Rates in 3 Years After Fed Hikes, But Is There a Connection?

Mortgage rates are based on movement in the bond market, and as of the middle of this week, bonds had lost a good amount of ground every day for **8 straight days.** With that, the average 30yr fixed rate officially hit its highest level in 3 years. That happened on the same day that the Federal Reserve hiked rates for the first time since 2018, but is there a connection?

The Fed's relationship with mortgage rates is quite interesting. The most popular misconception is that a Fed rate hike means higher mortgage rates, but that's not exactly how it works. In fact, there are many examples of the Fed hiking rates only for mortgage rates to fall.



Despite the paradoxical reality highlighted above, the Fed nonetheless has an extraordinary amount of influence over mortgage rates. One reason we don't see a more immediate correlation is that mortgage rates move every day whereas the Fed only meets to make rate decisions 8 times per year. The Fed also does a fairly good job of telegraphing probable rate changes (e.g. this week's was a 100% foregone conclusion). That gives the mortgage market ample time to adjust to changes in Fed policy before they happen.

The Fed also has other tools that affect mortgage rates, most notably, it buys Treasuries and mortgage-backed bonds (the financial instruments that most directly affect mortgage rates). When it merely **signals** an end to those buying programs, rates tend to spike rapidly. By the time changes are actually made, the market has already taken a majority of its lumps.

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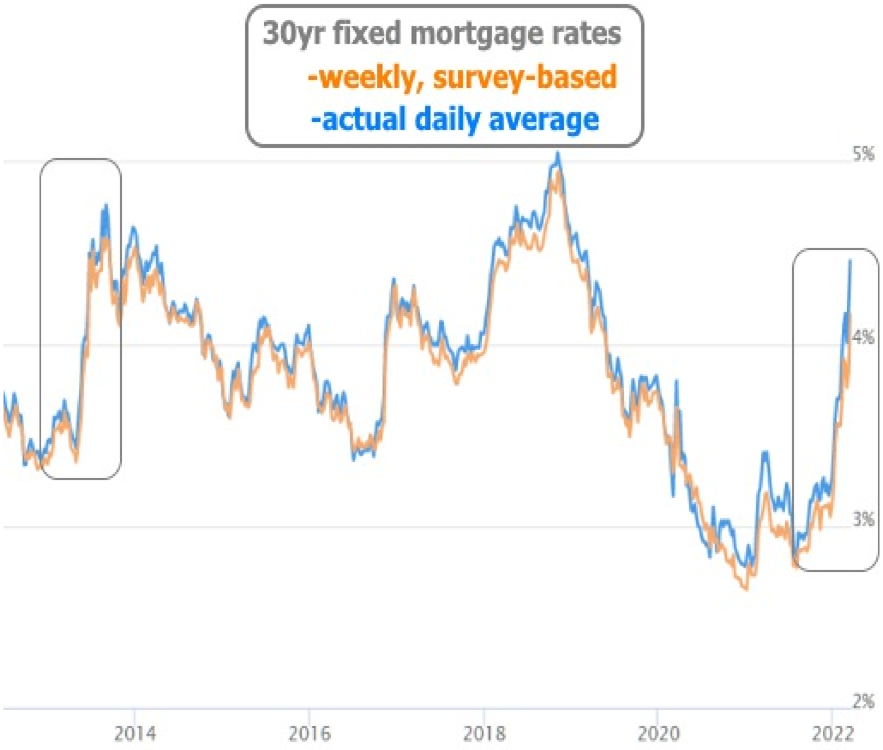
MORTGAGE ON A MISSION

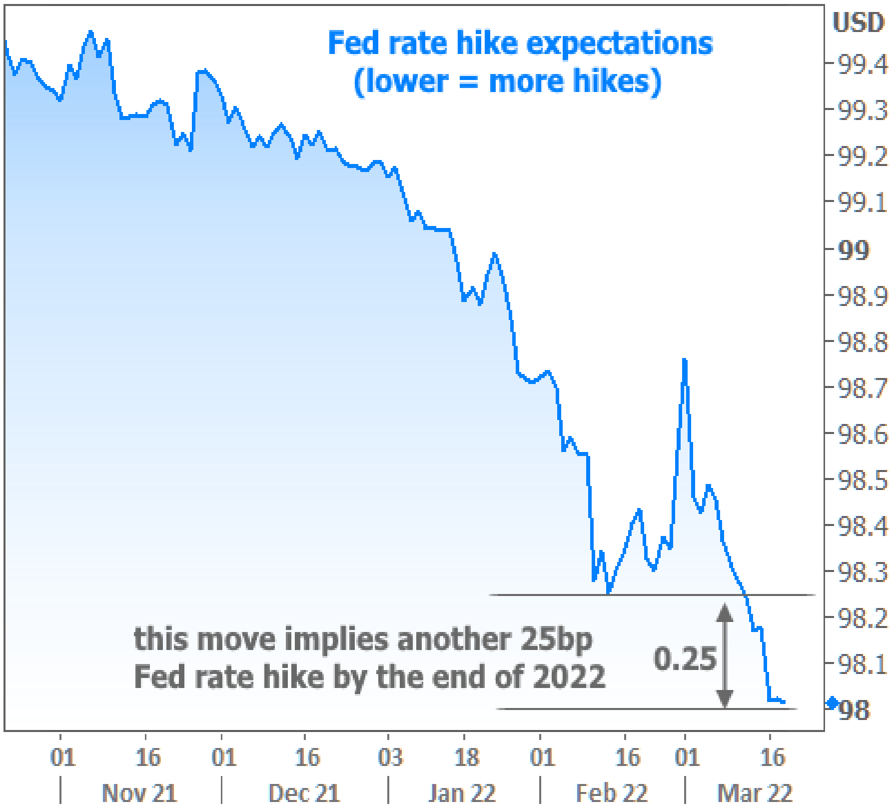
With mortgage rates having risen at the historically rapid pace of 1.25% in 2.5 months, we've certainly taken quite a few of the lumps destined for this particular bout of Fed policy tightening. Whether it's a true "majority" remains to be seen, but that's certainly possible. If it feels too early to start thinking about a supportive ceiling in mortgage rates despite the numerous additional Fed rate hikes expected over the course of 2022, consider what the mortgage market has already done to adjust for a less friendly Fed. In the following chart, both rectangles are the same size. In other words, the current rate spike is already bigger than that seen during 2013's infamous "taper tantrum."



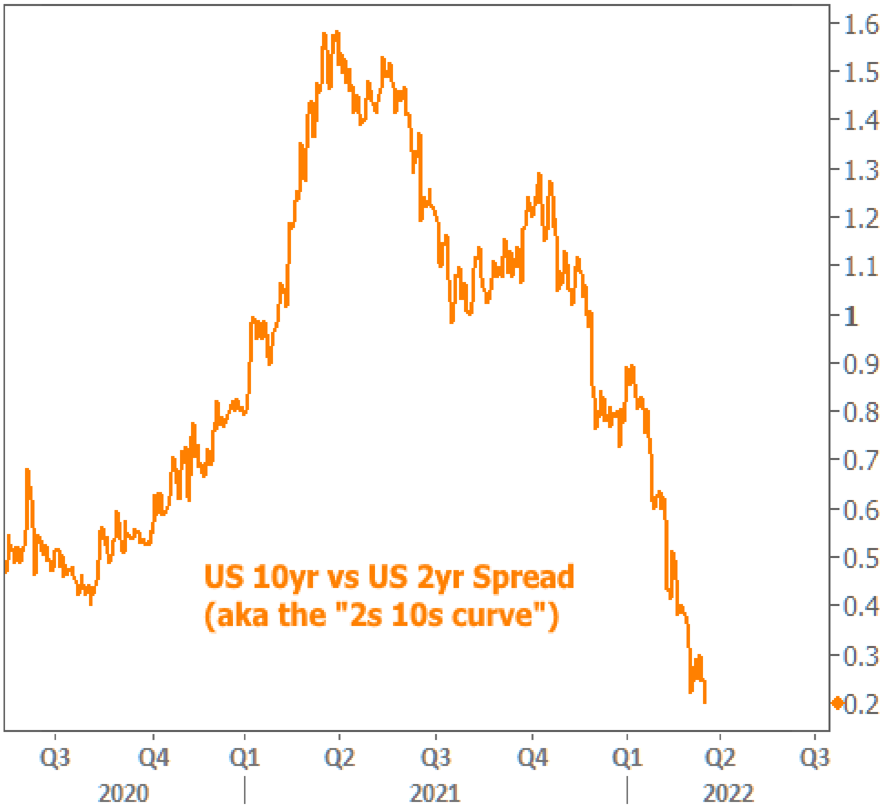
To be clear, this by no means guarantees a bounce. The only point is to convey that the bond market does what it can to move in advance of shifts in Fed policy. We won't really know the extent of that achievement until we see where things actually bounce.

Beyond that, there are big picture bounces and smaller scale corrections. It's too soon to discuss a big picture bounce, but this week's market movement suggests we're currently in the middle of one of those small scale corrections. This can be seen in the following chart of 10yr Treasury yields where momentum has shifted from "skyrocketing" at the beginning of last week to "consolidating" (higher lows and lower highs) by the end of the current week.

That's the 10yr though, and it hasn't been tracking with mortgage rates as well as it usually does. Shorter-term Treasuries (like the 2yr) have been doing much worse because they're much closer in duration to the Fed Funds Rate (the thing everyone is talking about when they say "the Fed hiked rates"). The Fed Funds Rate applies to money that's borrowed for less than 1 day, and there's much less of a gap between 1 day and 2 years than between 2 years and 10 years. With that in mind, here's what the market thinks about where the Fed Funds Rate is going:

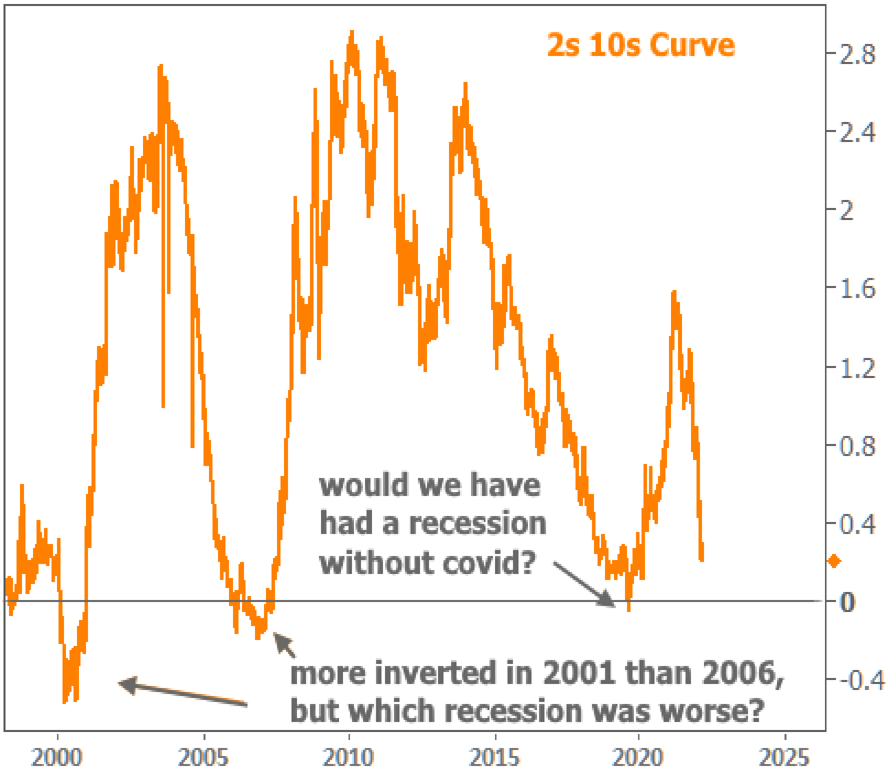


In other words, this week's Fed announcement helped the market understand that the fallout from the Ukraine war does nothing to slow down the rate hike outlook. If anything, the Fed is concerned it will only add to inflation, thus forcing even faster rate hikes (markets now see another 25bp hike compared to last week). To reiterate, the Fed Funds Rate has a bigger impact on shorter-term bonds. 10yr Treasuries, on the other hand, are more protected. The following chart shows the gap between 2yr and 10yr Treasury yields. The lower the line, the lower 10s are compared to 2s.



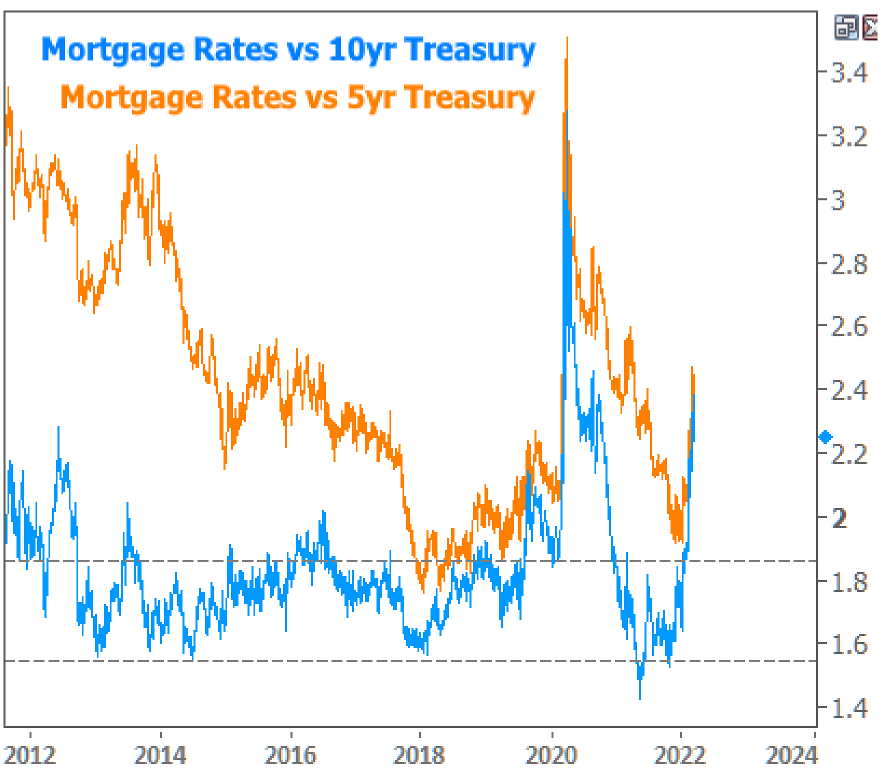
The 2s 10s curve (or "yield curve") is often discussed as a surefire recession indicator when the orange line goes below zero (aka "inverted yield curve"). If the current trend continues, it won't be long before the curve inverts again. But is it a surefire sign of recession?

All we can know is that it has generally been this way in the past. We don't really have any great examples of curve inversion in the age of quantitative easing (the Fed's big bond buying campaigns). As seen below, 2019 is the only candidate, and we'll never know if that microscopic curve inversion would have brought about a recession because covid happened a few months later. One thing we **CAN** observe about the yield curve is that the size of the inversion does **NOT** correlate with the size of the recession. So at the very least, this may be an imperfect predictive tool, but only time will tell.



To bring all of this esoteric "yield curve" business back to the world of mortgage rates, it's important to understand that, although a 30yr fixed mortgage may technically be able to last 30 years, most don't. The average life span tends to operate in a 5-10 year range. It's always a bit of a moving target because it's a consumer's choice to move or refinance. Analysts agree that the average life span is much shorter than normal right now and that's not doing mortgage rates any favors.

To understand why, just consider the 2yr vs 10yr concept above. In that example the shorter-term rate is moving higher faster than the longer-term rate. The same holds true for 5yr Treasury yields, which are a much more direct match for the estimated life span of a mortgage these days. As such, it's no surprise to see mortgage rates doing better versus 5s than 10s. The following chart shows the gap between 30yr fixed rates and 5/10-year Treasury yields. The higher the line, the worse mortgage rates are doing compared to the broader bond market.



Even when we focus on the 5yr Treasury note, mortgage rates are still spiking by comparison. This is a result of multiple factors. Some of them have to do with esoteric bond valuation issues that arise at times of rapid market movement. The simplest factor, however, is that the Fed is no longer buying new MBS or Treasuries and relative to the total size of the market, the Fed constituted a bigger percentage of guaranteed buying demand for mortgages. Lower relative demand = lower prices and higher yields (aka "rates") all other things being equal.

Are lenders being greedy? Actually, no. The following chart shows the average 30yr fixed rate versus mortgage-backed securities (MBS) levels. The lower the line the tighter lender margins are, in general. Due to increased costs that hit the market after covid, we wouldn't expect a quick return to the historical baseline, but other than that, margins are as tight as they've been since the start of the pandemic.