Fed Hikes Rates. Mortgage Rates Drop. Here's How That Works

For some, this will be old hat. For others, there's a mystifying dynamic that demands explanation. The confusion stems from years of being conditioned to believe that when the Fed "hikes" or "cuts" rates that mortgage rates move accordingly. That's actually not exactly how it works.

The Fed is currently in a rate hike cycle, so we'll focus on that. Today was the latest installment with an as-expected 0.25% increase to the Fed Funds Rate.

There are two important points in that last sentence. First off, the rate hike was entirely "as-expected." That means the market was able to fully prepare for it in advance. One portion of the market in question is that of mortgage-backed securities (MBS). These are basically bonds that are guaranteed by pools of mortgage loans. As investor demand waxes/wanes for those securities, the value of a mortgage changes in the eyes of investors. This is what determines day to day mortgage rate movement above all else.

The Fed only has 8 scheduled meetings to hike/cut rates per year whereas MBS can move as frequently as they want on any given business day. All that to say that if the market knew the Fed would hike 0.25%, it has long since been baked into MBS prices as well as the rest of the bond market.

The second important point is that the Fed deals with the "Fed Funds Rate." This is a target range for the shortest-term lending among large financial institutions. The easiest way to think of it is like the Fed setting the rate of return on a savings account. The higher it is, the more banks will park money there and the higher rates they must charge other banks and clients to borrow money (otherwise it makes more sense to just park the money in the bank and earn that interest).

The Fed Funds Rate may correlate with mortgage rates over very long time horizons, but there can be weeks and even months where they move in the opposite direction. That's because mortgages last many years on average as opposed to less than 24 hours for money borrowed at the Fed Funds Rate. Long and short term rates often move in different directions or at least at different paces.

All that to say that longer term bonds had a great day today even though the Fed hiked. The improvement was most easily chalked up to Fed Chair Powell's surprisingly open-minded disposition at the press conference that followed the official announcement. While he did say there was more work to do on inflation, he also said that high rates are only necessary as long as the economic data demands it. If data were to suggest a rapidly weakening economy and a bigger drop in inflation than has already been seen, the Fed could even begin cutting rates before the end of 2023. Granted, this isn't the Fed's base case, but it's an eventuality the Fed Chair is at least willing to entertain.

As bonds improve during any given business day, mortgage lenders have the option of lowering their rate offerings. Most do, lest they lose business to rivals who are offering improvements. Some lenders also have policies that allow for rates to be re-locked if the market moves enough, so if it looks like things are headed in that direction, it makes sense to offer a rate with less risk of needing to be changed.

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The net effect is a conventional 30yr fixed rate that is back down in the 6% neighborhood for top tier scenarios. Different lenders will approach this reality in different ways. Some of the more aggressive examples were already quoting rates in the high 5% range. Others are still in the mid 6's. There can be reasons for those differences that make them a lot more similar than it may seem at first glance (upfront costs, mortgage insurance, buydown programs, loan type discrepancies, etc). The bottom line though is that the average lender is now back in line with the lowest levels in roughly 5 months.