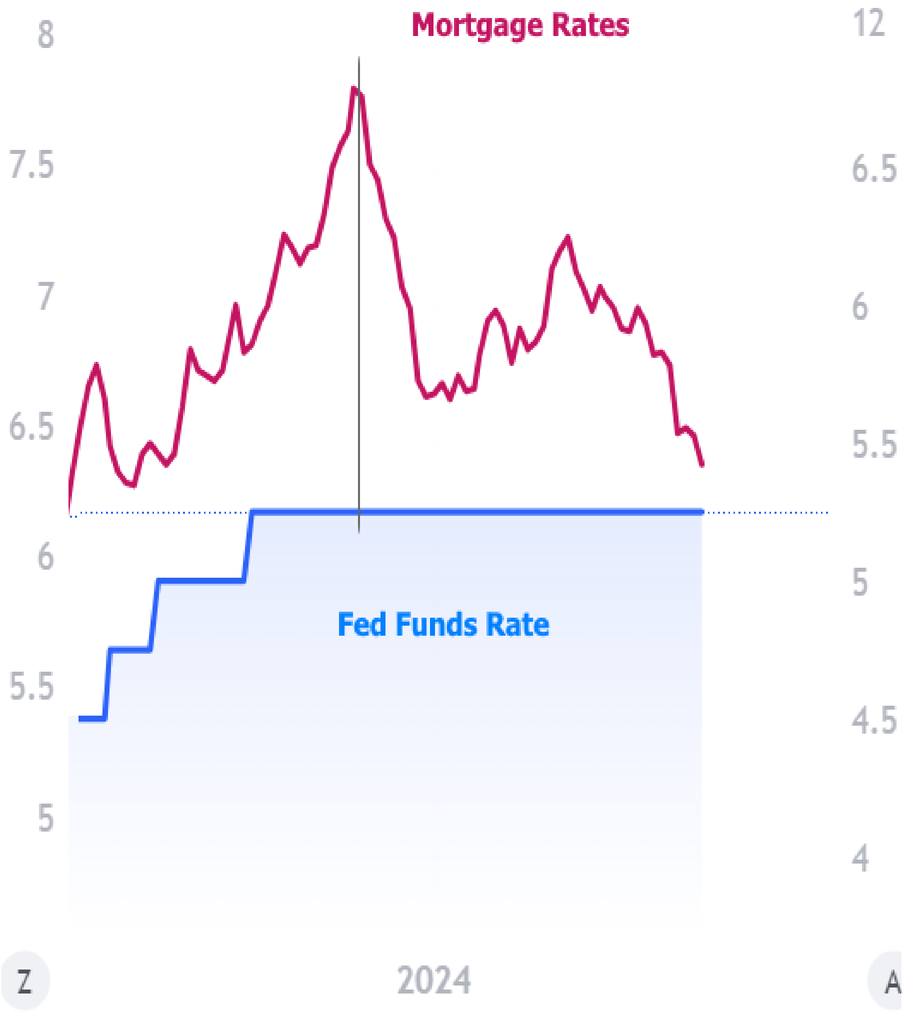
Here's Exactly What a Fed Rate Cut Will Do For Mortgage Rates

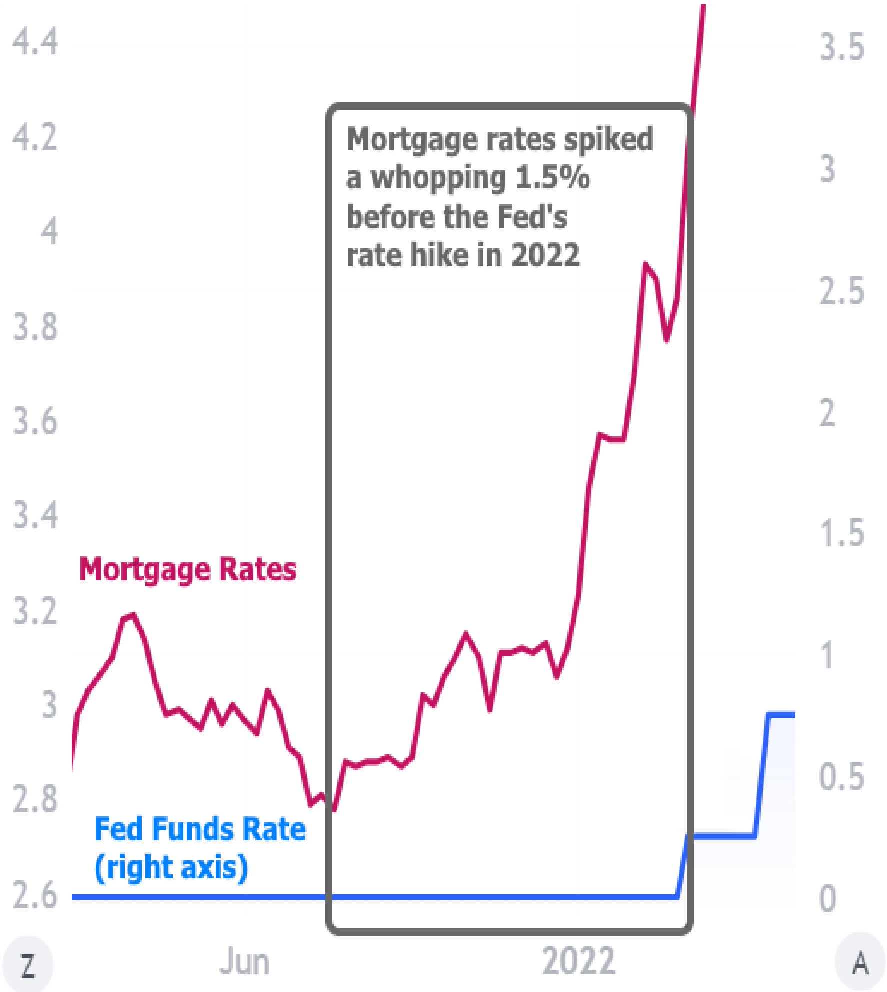
It's still just over 3 weeks away, but questions are already ramping up regarding the impact of the Fed's rate cut on mortgage rates. Here is exactly what the rate cut itself will do: NOTHING!

The easiest way to understand why is to ask yourself how mortgage rates have been able to move down by more than 1.5% since late 2023 despite the fact that the Fed never cut rates during that time.

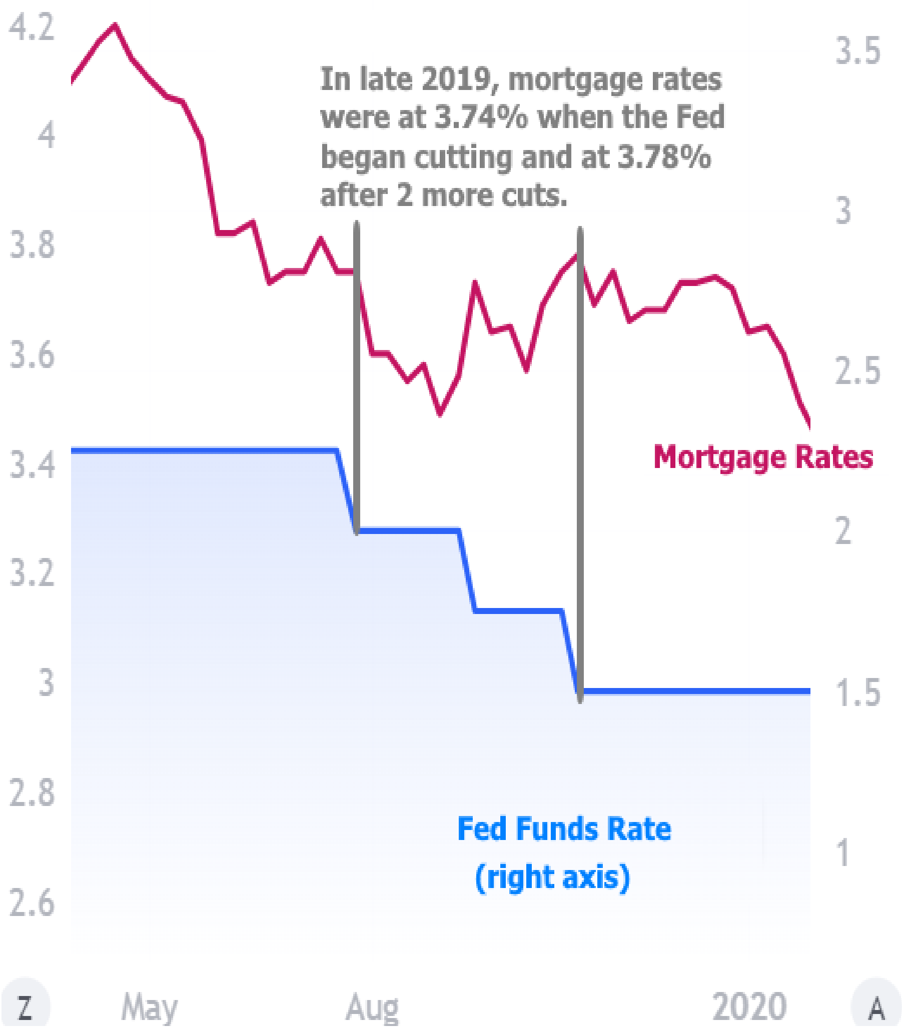


The same principle works in reverse as well, as seen during the massive rate spike in early 2022 when mortgage rates moved 1.5% higher before the Fed ever hiked.

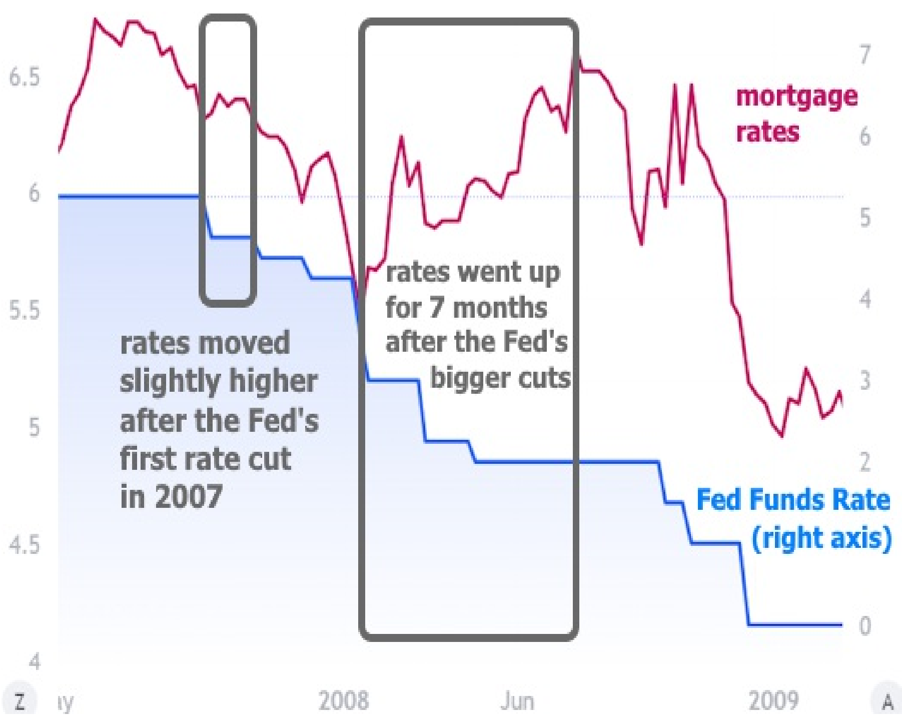
Jim Spinner
Home Buying Concierge, US Wide Financial LLC
P: (314) 495-3941
2200 Westport Plaza Dr
St. Louis Mo 63146
NMLS: 410323
NPN 12396063

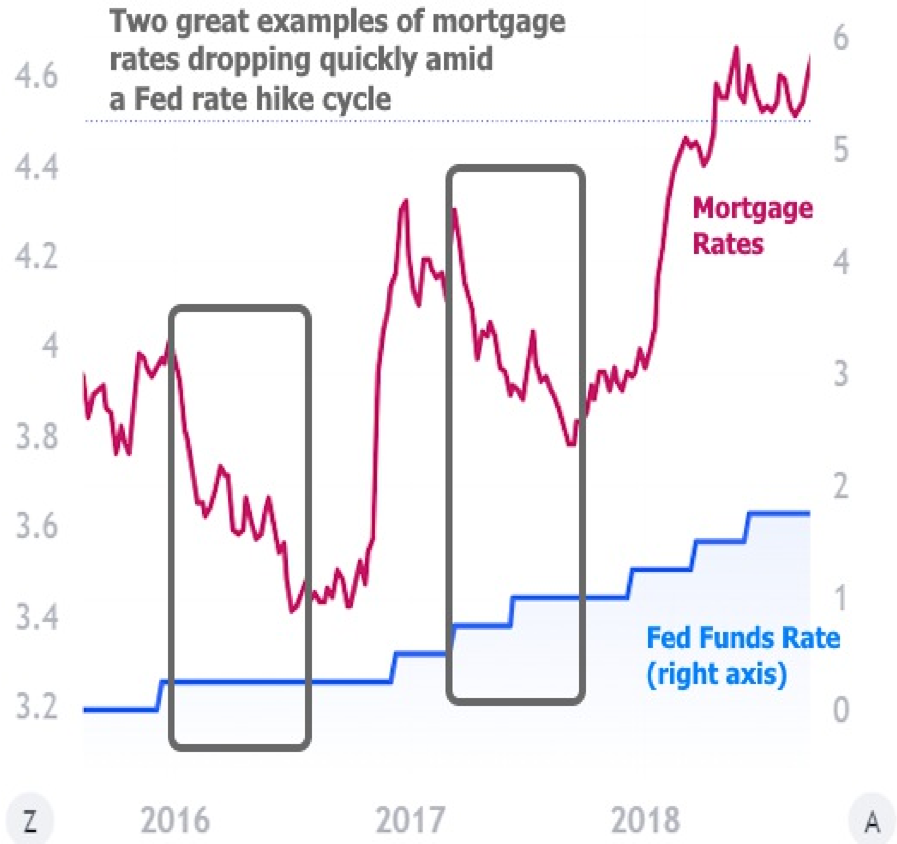


How about an example from the last time the Fed actually cut rates in a non-emergency scenario? In late 2019, the economy was slowing and inflation was at bay, so the Fed began cutting at a similar pace to what the market is expecting in late 2024. There were 3 rate cuts of 0.25% and mortgage rates actually moved HIGHER during that time.



And here are several other examples of mortgage rates paying no attention to the Fed Funds Rate.

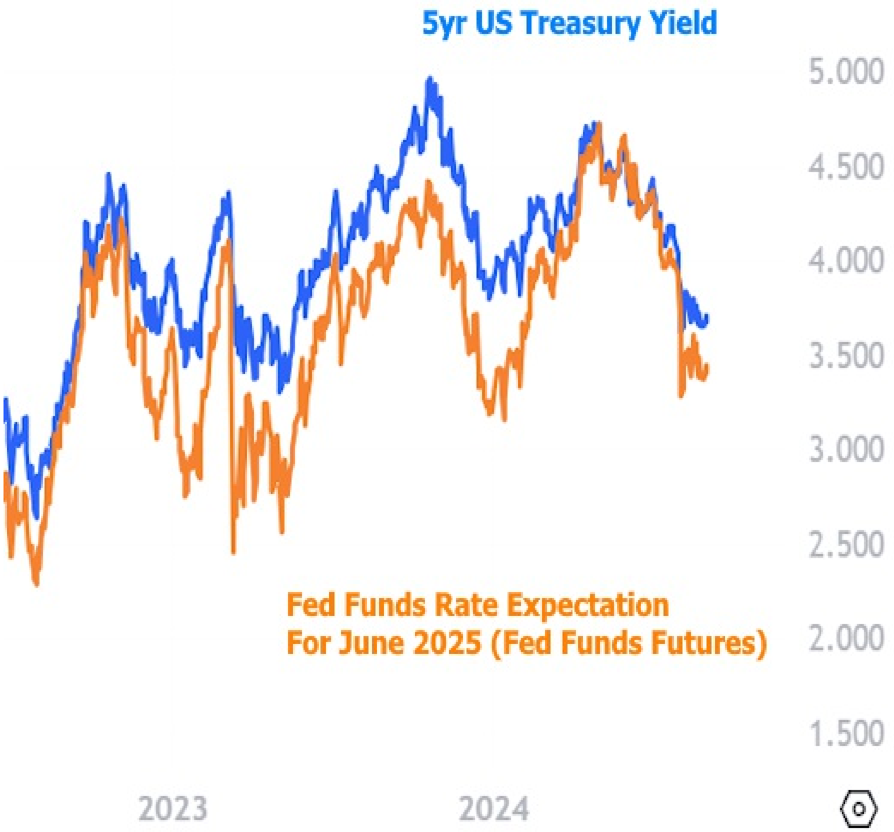




This isn't a mortgage-specific phenomenon. The charts would look the same for any other mainstream interest rate. That's because the Fed only has 8 times it can change rates on any given year (apart from the extraordinarily rare "emergency cut"). Contrast that to the bond market--the source of movement for all manner of interest rates--which frequently moves more than 8 times in any given second.

In other words, the financial market is able to make its move well in advance of the Fed and that's a substantial part of the explanation for the drop in mortgage rates seen over the past year. The bond market is "pricing in" the policy shift that the Fed finally confirmed in recent weeks. In fact, there are even financial markets that specifically bet on future levels of the Fed Funds Rate (unsurprisingly called "Fed Funds Futures").

These futures correlate very well with certain bond yields which, in turn, correlate very well with mortgage rate movement. The 5yr Treasury is a good example at the moment.



Bottom line, by the time the Fed cuts in September, the financial market and mortgage lenders will have LONG since adjusted rates accordingly (and they arguably already have).

NOTE: this does not mean that rates won't move between now and then, or that they are forbidden from falling after the Fed cuts its policy rate. It's just that those potential movements will be based on other considerations (chiefly, incoming economic reports) and NOT on the Fed's rate cut.

To make matters more confusing, it's important to remember that Fed policy still has a tremendous impact on rates, but that impact stems from the Fed's words and quarterly projections. Frustratingly, those projections are released at the exact same moment as the Fed's rate decision and there's every chance that September's installment will cause some volatility in the bond market.

For instance, if the Fed's projections are surprisingly friendly, mortgage rates could fall sharply on Fed day and many uninformed onlookers will falsely conclude that the Fed rate cut was the thing that did the trick.

One caveat to all of the above is that these conclusions are only as good as the market's understanding of the Fed's probable course of action. Fortunately, since 2008, the Fed has unequivocally telegraphed rate changes in advance. The only real opportunity for "surprise" is in a situation where the market is split between expecting different sizes of cuts. Notably, this could certainly be the case on the eve of the September rate announcement.

We'll know more about the market's expectations for the size of the rate cut after we see the first two weeks of economic data in September. The upcoming week has several of the big ticket reports that have strong track records of causing rate movement. Friday's jobs report is particularly important this time around as it has a chance to reiterate or retract the rate-friendly message sent by the previous installment.

Simply put, another weak report would greatly increase expectations for a 0.50% Fed rate cut whereas a stronger report would all but guarantee a 0.25% cut. In either case, mortgage rates won't wait for the Fed before reacting.