

What Might a Fed Rate Cut do For Mortgage Rates?

Mortgage rates have fallen nearly 2% from last year's peak. Much of that decrease can be viewed as the normal phenomenon of longer term rates getting in position for changes in short term rates. The point we're about to make is that mortgage rates have already adjusted for what the Fed is likely to do--not just at this meeting, but many of the upcoming meetings as well.

The Fed Funds Rate is an "overnight" rate. It is the rate on a loan of less than 24 hours. A 30yr fixed mortgage rate is a loan for anywhere from 3-10 years depending on a number of variables. Why not 30 years? Simply put, most people sell or refinance well before the 30 year mark. Investors care about the average life span and that's where the 3-10 year time frame comes in.

For the sake of easy comparison, let's say a mortgage is most analogous to a 5 year loan. That means it would act more like a 5yr Treasury yield (Treasuries are the vanilla, risk-free benchmark for all other rates in the U.S.). The Fed Funds Rate is essentially a 1 day Treasury yield.

From there, investors assign value to loans/bonds based on their going rate and the market's preference for holding certain durations of bonds. Longer term bonds tend to reflect the current short term bonds + the outlook for how those short term bonds will change over time. In other words, if you could know what the Fed Funds Rate would do over the course of the next 2 years, you could know a lot about how a 2 year Treasury yield should look today.

It's for this reason that a 2yr Treasury yield is just over 3.5% while the Fed Funds Rate is still at 5.375 for almost 1 more day.

Mortgage rates may be higher than the Fed Funds Rate, but that's to be expected given that there's a normal spread between mortgage rates and risk-free benchmarks like Treasuries. If we're using the 5yr Treasury, that spread is about 2.5%. The important development is that both 5yr Treasury yields and mortgage rates have fallen more than 1.5% from the late 2023 peak. Both are doing about the same to reflect their belief in a lower path for the Fed Funds Rate in the coming months and years.

The path could always change, and it will, but the nature of the changes depend on how the economy evolves. Traders have to go with their best guess for now. That means they're fairly well split between the Fed cutting by 0.25 or 0.50% tomorrow. Some traders will be surprised and that can create volatility.

But the volatility isn't as simple as the realization of the size of the rate cut. There's also the matter of the Fed's Summary of Economic Projections. This includes a dot plot that outlines each Fed Member's view of the appropriate Fed Funds Rate at various points in the future. The change in the so-called "dots" could easily become the dominant theme of the day. It's such a big consideration that it could push interest rates higher even if the Fed cuts by 0.50% (and vice versa).

The most important takeaway is that lower mortgage rates are not only not remotely guaranteed by tomorrow's Fed rate cut. They're actually already baked in. Tomorrow's directionality depends on the dot plot and Powell's comments in the press conference. Things could go either way and the volatility could be significant.



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