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Higher Rates Deserve Attention, Not Panic

This week's key story was the big spike in interest rates. Is it something that deserves our attention? Certainly, and we've given the broader move higher in rates plenty of attention. Is it the end of the world for the housing market? Certainly not.

What Happened?

In short, rates for mortgages and other long-term debt moved up to the highest levels in roughly 7 years

Why Did It Happen?

There are short-term and long-term scapegoats. We've talked quite a bit about the long-term factors and they account for most of the move toward higher rates of the past few years, in general. Think of these as an unfriendly backdrop against which the day-to-day tragedies and comedies play out. They include:

- **Increased bond issuance** associated with government spending and/or revenue shortfalls. Higher bond issuance = higher rates, all things being equal.
- **Tightening of monetary policy** at home and abroad (things like the Fed's rate hike outlook and the normalization of its bond market holdings)
- **Risks of increased inflation and growth**, both of which are associated with higher rates, all other things being equal. Granted, super high growth and inflation are far from guaranteed, and that's why the Fed Funds Rate (and mortgage rates, for that matter) remain historically low compared to the pre-Financial Crisis era

This week's short-term backdrop included a Retail Sales report that was strong enough to allow bond traders to take the next step in adapting to the realities outlined in the bullet points above. This raises a very important point, because in and of itself, the Retail Sales data was merely "as expected," yet it was at the scene of a the beginning of this week's rate spike.

The important point is this: as long as the government can keep ramping up bond issuance at the same time the Fed is tightening policy, all without having a noticeably adverse affect on economic data, bond traders will continue to plan on rates moving gradually higher.

National Average Mortgage Rates

	Rate	Change	Points
Mortgage News Daily			
30 Yr. Fixed	7.28%	-0.09	0.00
15 Yr. Fixed	6.75%	-0.07	0.00
30 Yr. FHA	6.70%	-0.12	0.00
30 Yr. Jumbo	7.48%	-0.07	0.00
5/1 ARM	7.35%	-0.07	0.00
Freddie Mac			
30 Yr. Fixed	7.22%	-0.22	0.00
15 Yr. Fixed	6.47%	-0.29	0.00

Rates as of: 5/3

Market Data

	Price / Yield	Change
MBS UMBS 6.0	100.09	+0.31
MBS GNMA 6.0	101.03	+0.29
10 YR Treasury	4.5138	-0.0657
30 YR Treasury	4.6711	-0.0579

Pricing as of: 5/3 5:04PM EST

Recent Housing Data

		Value	Change
Mortgage Apps	Apr 24	196.7	-2.67%
Building Permits	Mar	1.46M	-3.95%
Housing Starts	Mar	1.32M	-13.15%
New Home Sales	Mar	693K	+4.68%
Pending Home Sales	Feb	75.6	+1.75%
Existing Home Sales	Feb	3.97M	-0.75%
Builder Confidence	Mar	51	+6.25%

This week seemed like a bigger deal because long-term ceilings were broken (you'll notice more than a few headlines about "7-year highs"), but to those in the know, it would have been a surprise if those big-picture bullet points **didn't** eventually carry rates past that ceiling.

None of this is to say that the highest rates in 7 years aren't a big deal, simply that higher rates have been expected, and the journey upward has been relatively orderly given the nature of the headwinds.

Any Specific Challenges For Mortgage Rates?

Yes, actually! Rates, in general, are based on trading levels in the bond market. But mortgage rates aren't automatically determined by bonds. Mortgage LENDERS have the final say. After all, it's the lender that is responsible for funding your mortgage and for guaranteeing the availability of a locked rate. Both of those functions could become more expensive for lenders if volatility increases.

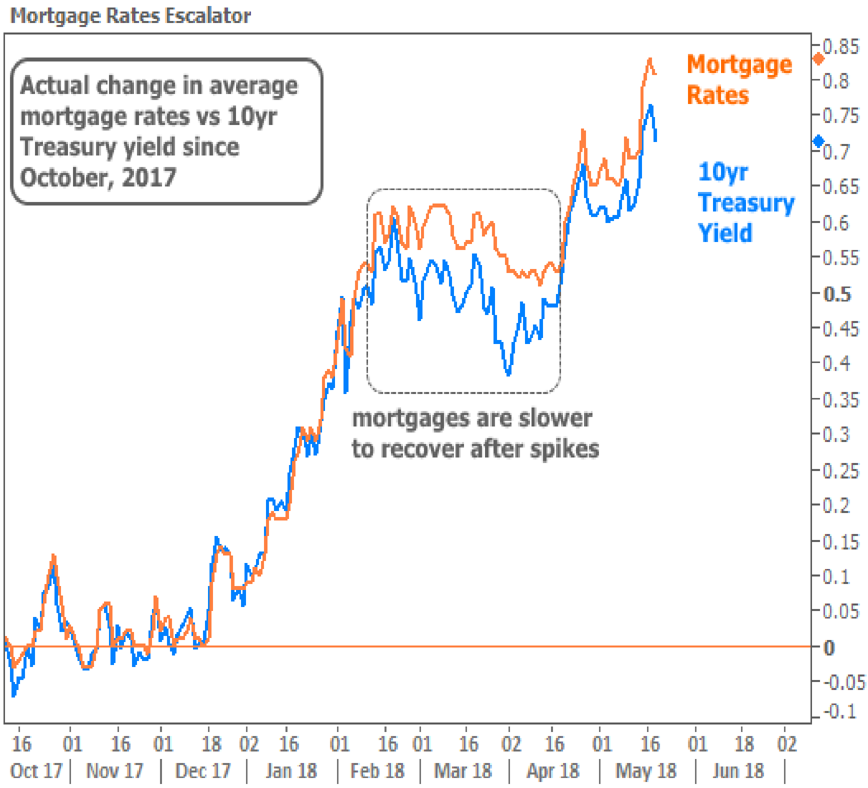
With that in mind, lenders tend to raise rates quickly when benchmark rates (like US Treasury yields) are rising quickly--especially if they're rising to long-term highs. Moreover, they tend to be more cautious about moving rates back down. That means Treasury yields typically improve more than mortgage rates after spikes like the one seen this week. In fact, in cases where improvements in rates only last a few days, it's not uncommon to see Treasury yields improve significantly while mortgages barely budge.

Is That "Barely Budging" Thing Going to Happen This Time?

This already began happening on Friday. 10yr Treasury yields fell the better part of 0.06% and mortgage rates were lucky if they saw half that. Because mortgage rates are typically offered in .125% increments, that means Friday's rates were the same as Thursdays. The improvements come in the form of lower upfront costs, which technically lowers the "effective rate."

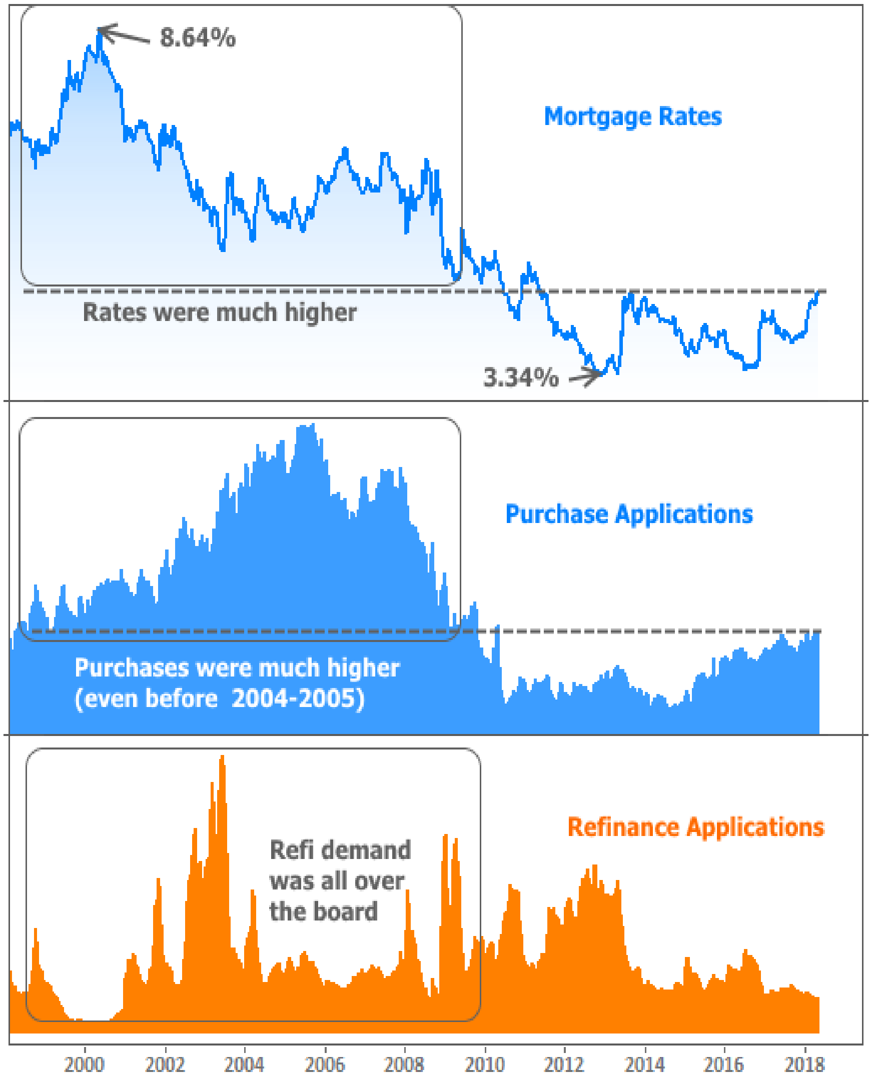
All that to say that if there were no closing costs and only interest rates tied mortgages, the average lender would have only improved by about 0.02% compared to 3 times that amount in the Treasury market.

As to whether or not rates "barely budge" from here on out, everything that traders can possibly know about the future is already priced-in to current trading levels. We can't know ahead of time if bonds will continue to recover next week. We can only know that--if they do--mortgage rates are likely to recover by a smaller amount.

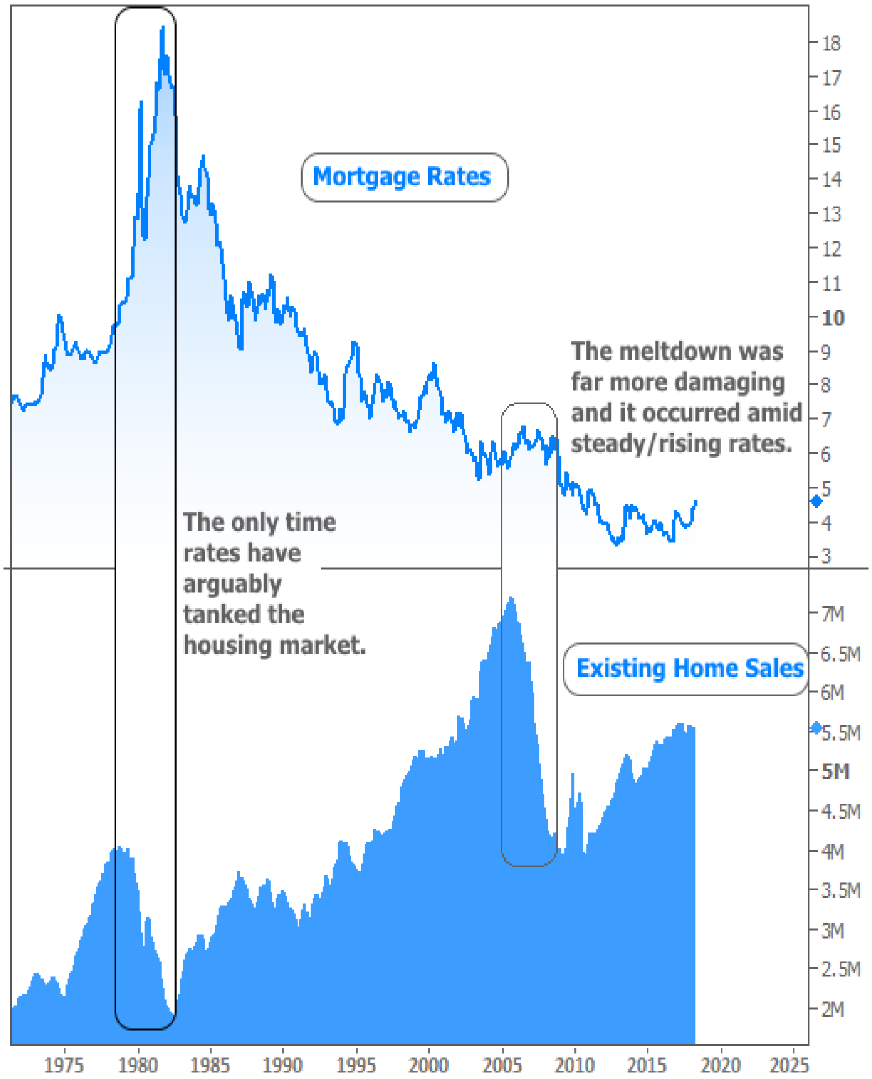


What's The Fallout So Far? Will This Affect The Housing Market?

There are always plenty of scary headlines about mortgage rates when they begin rising quickly or when they hit the highest levels in a long time. As you can well imagine, SOME prospective buyers will make different decisions in a rising rate environment. But history is clear in showing that a big spike in rates isn't a deal-breaker in the bigger picture. The most obvious fallout is always on the refinance side of the mortgage market.

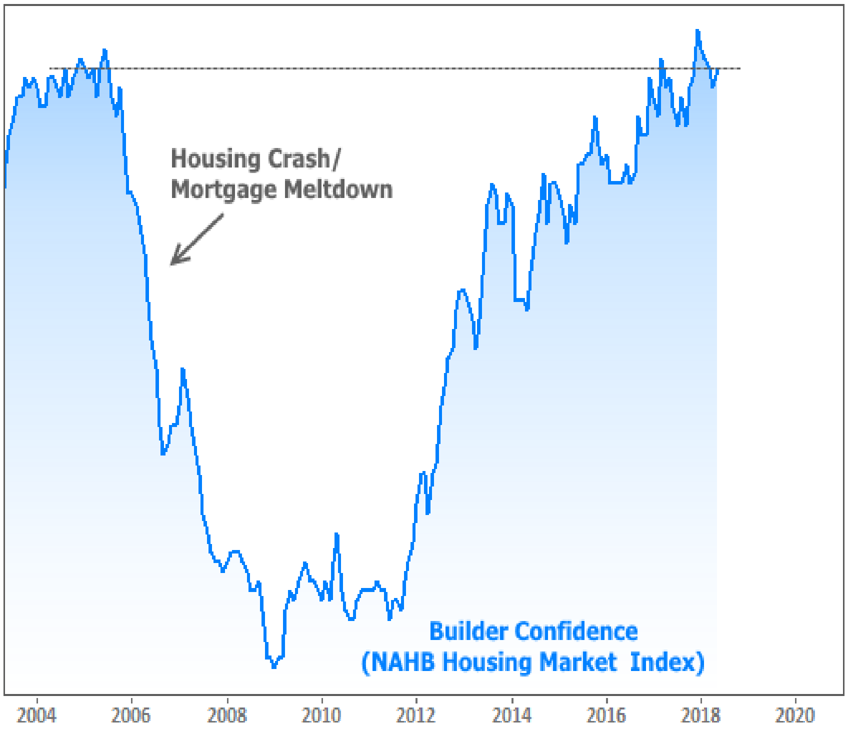


The only exception would be a rate spike so massive that it rivaled that of the early 80's. Fortunately, even the most pessimistic rate forecasters agree that won't happen. But just for the sake of argument, let's imagine it could happen. If it did what it did in 1980, and took sales back to their most recent lows (1975), the modern day equivalent would be the recent lows from 2010. That wouldn't be "fun," but it still wouldn't be the end of the world.

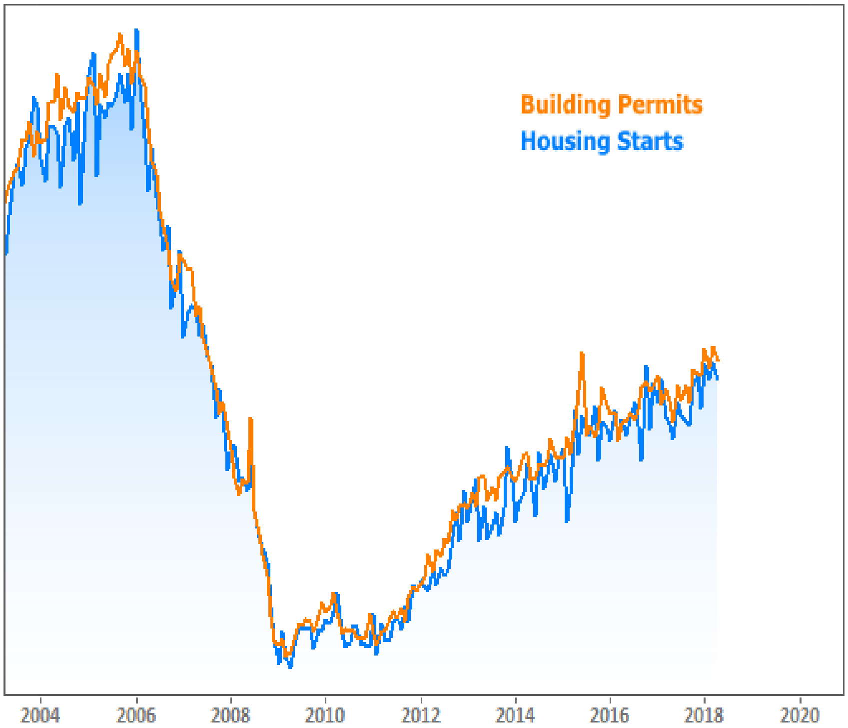


Again though, a 1980's style rate spike is not in the cards. Investors know that we have been in a rising rate environment and that it could continue. While it makes for some short term alarm, and while we expect to see some contraction relative to the previous pace of sales, this week's housing-related data speaks for itself.

Builder Confidence



Residential Construction



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