Rich E. Blanchard
Managing Director, RICH Home Loans LLC
NMLS: 492461
1550 Wewatta St., 2nd Floor Denver, CO 80202

Office: 720.619.9900
Mobile: 303.328.7047
Fax: 214.975.2874
richblanchard@richhomeloans.com
View My Website

The Day Ahead: The Absolutely Ridiculous State of Mortgage Rates vs MBS vs Treasuries

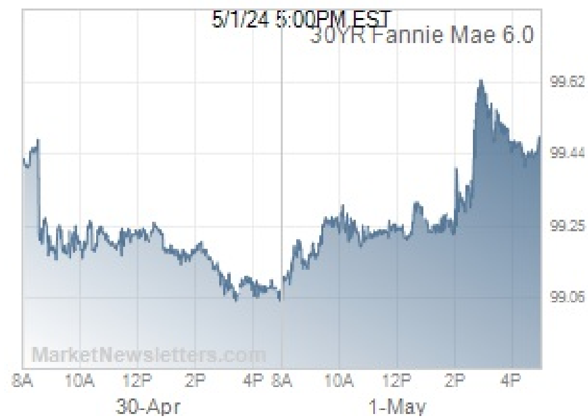
Following yesterday's sharp losses, the bond market didn't do much overnight, nor is it doing much to push back in the other direction this morning. In fact, 10yr yields are starting out at their highest levels since the Pfizer vaccine sell-off in early November, and those were the highest levels since March. Moreover, the weakness made for a perfect technical bounce on the lower line of the trend channel we've been tracking. From a purely technical perspective, the implication is to once again challenge (or "re-test") the recent highs, at a minimum. We're close enough to those to consider that a work in progress, actually. The scarier scenario would be a move to the upper trend line.

In thinking about scary scenarios, it's definitely one of those precious few historical moments where we absolutely have to differentiate between MBS and Treasuries (99% of the time, this only matters on an intraday basis). Fortunately, MBS are **nowhere near** their November lows (remember, higher = better in the following chart, because it's in PRICE as opposed to YIELD).

MBS & Treasury Market Data

	Price / Yield	Change
MBS UMBS 6.0	99.46	+0.40
MBS GNMA 6.0	100.48	+0.27
10 YR Treasury	4.6300	-0.0045
30 YR Treasury	4.7540	+0.0026

Pricing as of: 5/1 9:25PM EST



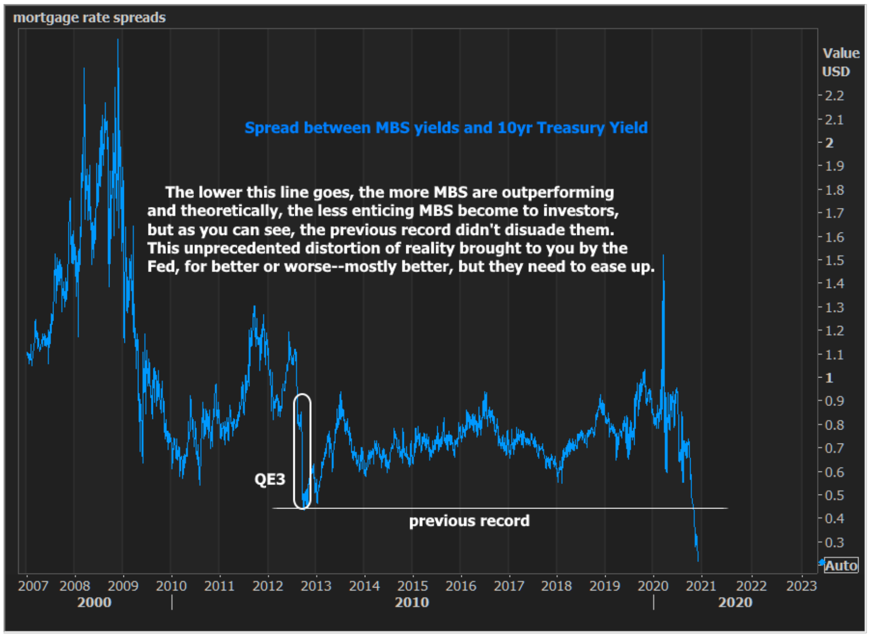
Average Mortgage Rates

	Rate	Change	Points
Mortgage News Daily			
30 Yr. Fixed	7.41%	-0.10	0.00
15 Yr. Fixed	6.84%	-0.06	0.00
30 Yr. FHA	6.88%	-0.11	0.00
30 Yr. Jumbo	7.60%	-0.07	0.00
5/1 ARM	7.50%	-0.05	0.00
Freddie Mac			
30 Yr. Fixed	7.17%	-0.27	0.00
15 Yr. Fixed	6.44%	-0.32	0.00
Mortgage Bankers Assoc.			
30 Yr. Fixed	7.24%	+0.11	0.66
15 Yr. Fixed	6.75%	+0.11	0.64
30 Yr. FHA	7.01%	+0.11	0.94
30 Yr. Jumbo	7.45%	+0.05	0.56
5/1 ARM	6.64%	+0.12	0.87

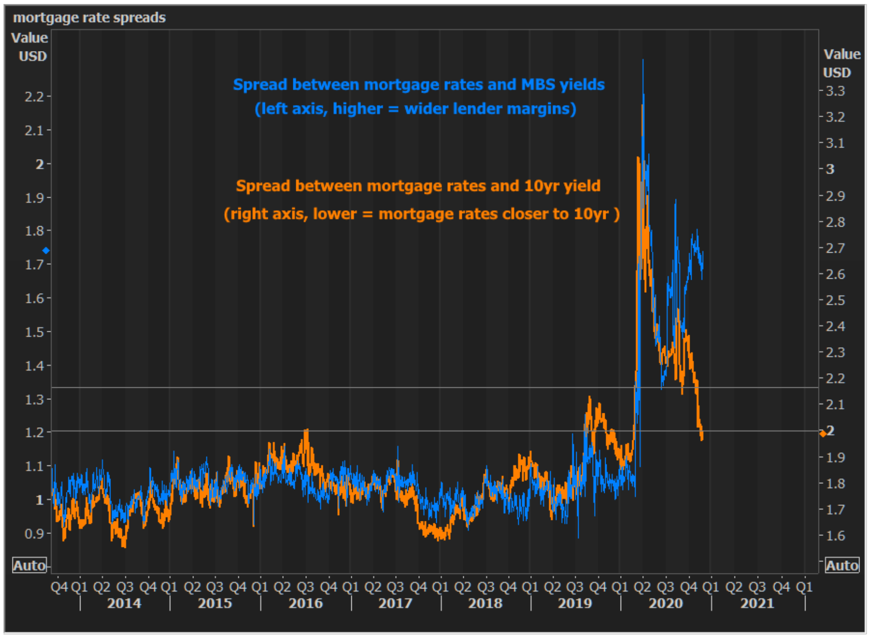
Rates as of: 5/1

The silver lining only gets brighter from there when we consider where mortgage rates are compared to MBS. To best compare MBS with rates (and with Treasury yields), we lean on the Eikon team's excellent calculation of a 30yr fixed "current coupon." There's a lot of complex math that goes into the calculation, but just think of it as "**MBS yield**." In other words, if you're an investor buying bonds, this is your "return" in the same way a 10yr Treasury yields about 94bps this morning.

The spread between MBS and Treasuries provides a gauge of **how cheap or rich** MBS are from an investor's standpoint. The lower/tighter the spread, the less buying demand there should be, theoretically. That theory has now been obliterated by a combination of overly-aggressive Fed MBS purchases and an unprecedented thirst for yield among investors. The latter is a logical byproduct of the low-yielding Treasury environment (and the government guarantee for MBS investors), but if the following chart could only lean on one cause, it would be the Fed.



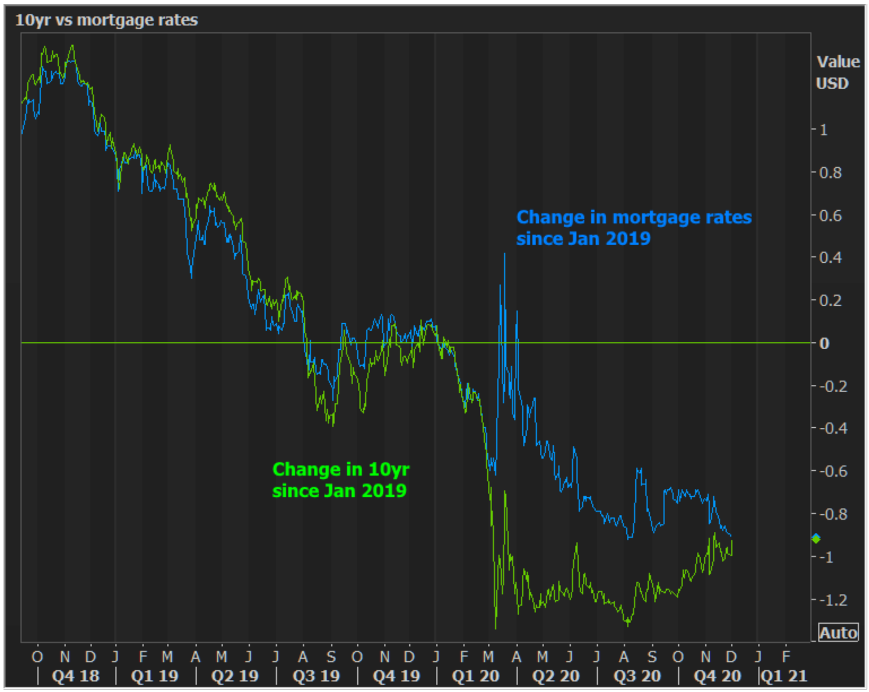
For those who are curious, the chart above is at .21%, which means MBS yields are 0.21% above 10yr yields or 1.15% (.94% 10yr yield + .21% spread). That MBS yield can also be considered against mortgage rates. Whereas the chart above might make us concerned that investors will shy away from MBS soon (frankly, that was a concern weeks ago and it has yet to slow things down), the chart below suggests that lenders have **A LOT** of room to lower rates and remain profitable.



It's hard to say exactly how much room lenders have because things are a bit different post-covid. The blue line probably couldn't get back to 1% in this environment (servicing/hedging/g-fee costs are all higher than they were when the blue line was stably sideways between .9 and 1.1), but they could easily drop roughly half a percent without lenders going hungry. **Simply put,** if MBS stop their trend of outperformance vs Treasuries, that means 10yr yields could be at 1.4% and 30yr fixed mortgage rates would be right where they are today.

In order for that to happen, however, the move to 1.4% would need to be slow, and of course the spread between MBS and Treasuries would need to remain as tight as it is. And in order **for THAT to happen**, the Fed would need to keep its MBS buying intact. The moment they indicate tapering (and that will happen at some point--probably in 2021), the **party is over**.

Bonus Chart: 10yr yields vs mortgage rates (absolute change from 2019). The gap between the two lines in the chart below is measured by the orange line in the chart above.



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