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Making Sense of Lower Mortgage Rates Despite Fed Rate Hike

The relationship between "Fed rate hikes" and mortgage rates can be confusing at first glance. After all, mortgage rates moved lower in the days and weeks following the past 3 Fed rate hikes. While they aren't necessarily repeating the same pattern this time around, mortgage rates were nonetheless **unfazed** by this week's Fed hike.



This dichotomy exists for **2 main reasons**. The **first** is more objective and basic. It has to do with the structure of the bond market and the way the Fed hikes rates. Almost everything in the bond market (including mortgage rates) is free to move every day while the Fed Funds Rate can only move 8 times per year at scheduled meetings. This means mortgage rates can adjust for expected changes in the Fed Funds Rate **ahead of time**. That's why you see mortgage rates topping out heading into the last 3 Fed rate hikes. They were bracing for the expected impact.

National Average Mortgage Rates



Mortgage News Daily	Rate	Change	Points
30YR Fixed	7.34%	+0.01	0.00
15YR Fixed	6.89%	0.00	0.00
30YR FHA	6.96%	+0.01	0.00
30YR Jumbo	7.45%	+0.01	0.00
7/6 SOFR	6.83%	+0.02	0.00
30YR VA	6.97%	0.00	0.00

Rates as of: 11/23

MBS and Treasury

	Price / Yield	Change
MBS UMBS 6.0	99.73	+0.18
10 YR Treasury	4.8889	-0.0573
30 YR Treasury	5.2773	-0.0311

Pricing as of: 11/24 12:08PM EST

Recent Housing Data

		Value	Change
Mortgage Apps	Nov 11	199.8	-2.35%
Building Permits	Oct	1.3M	-7.5%
Housing Starts	Oct	1.31M	+7.21%
New Home Sales	Sep	676K	-1.17%
Pending Home Sales	Oct	63	-4.69%
Existing Home Sales	Oct	3.99M	+0.25%
Builder Confidence	Nov	25	-13.79%

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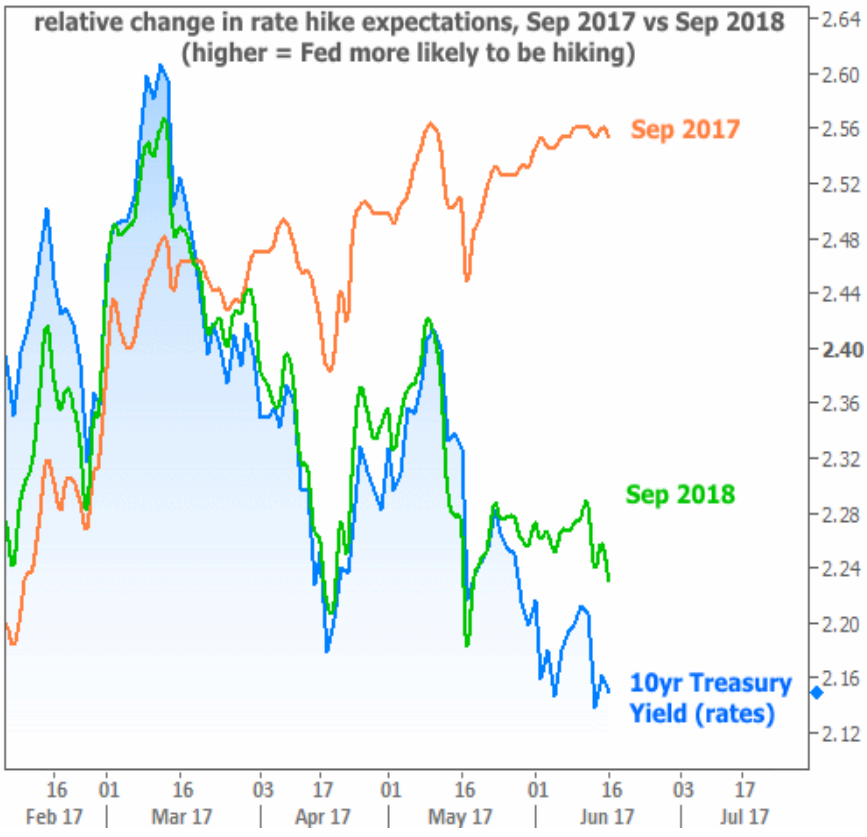
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The **second** and **more important** reason is **"duration"** (how long a particular fixed-income investment will last). Fixed-income refers to securities that allow investors to pay upfront for the right to receive principal and interest payments on a "fixed" schedule. Although mortgage rates and the Fed Funds Rate are both part of the fixed-income market, they keep two very different schedules, and that's a big deal for investors.

Just imagine you're a bank who makes **2 loans today:** one that will be paid back in full tomorrow and one that will last roughly 7 years. You're probably not going to offer the same terms on these 2 loans! Multiply that concept by the trillions of dollars circulating in the bond market--ranging in duration from "overnight" to "decades" and you can quickly appreciate why short-term rates don't move in tandem with longer-term rates.

Simply put, long-term and short-term rates care about different things. Short-term investors (think under 2 years) will be in and out of the market well before several longer-term risks might be realized. Long-term rates, on the other hand, must consider what inflation, growth, and Fed policy might look like many years in the future! This is precisely why longer-term rates have been **able to move lower** recently as the outlook for inflation, economic growth, and Fed rate hikes has cooled relative to previous expectations

That last part ("relative to previous expectations") is important. It means investors don't necessarily see inflation, economic output, or the Fed Funds Rate falling outright, but rather, simply not living up to previous expectations. One **great way to observe** this phenomenon is to look at the relative change in Fed rate hike expectations for this September and next September versus the 10yr Treasury yield (a ubiquitous benchmark for long-term rates). The following chart shows that markets have increasingly come to terms with the 2017 rate hike outlook, but now think the Fed will be much slower to hike in 2018. Unsurprisingly, longer-term rates line up better with the longer-term rate hike outlook.



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Another tacit implication of the chart above is that markets were well-aware that we'd see a Fed rate hike this week. As such, the hike itself was of little consequence. In fact, most of this week's downward movement in rates happened on Wednesday morning when key reports on inflation and retail sales fell well short of expectations. Traders figure the **Fed will have a hard time** sticking to its current rate hike trajectory if inflation and growth continue cooling. That's the nice way of putting it.

Some traders might say the Fed either has their collective **head in the sand** regarding the absence of convincing inflation. Others might say the Fed just isn't fully broadcasting its motivation for removing accommodation (i.e. raising rates and decreasing balance sheet reinvestments by the end of the year).

This quasi-conspiracy theory holds that the Fed **wants to get ahead** of the next economic downturn with rates high enough to cut, and a balance sheet small enough to expand. In the Fed's defense, they've fully admitted to this line of thinking, but have stopped short of including it in official policy verbiage (likely because it would do more harm than good to list "getting ready for an impending recession" as a driving force behind policy changes).

This latent belief that the Fed is a bit too optimistic (regardless of the reason) is consistent with interest rates' ability to **hold their ground** despite the fact that stocks continue to operate near record levels.

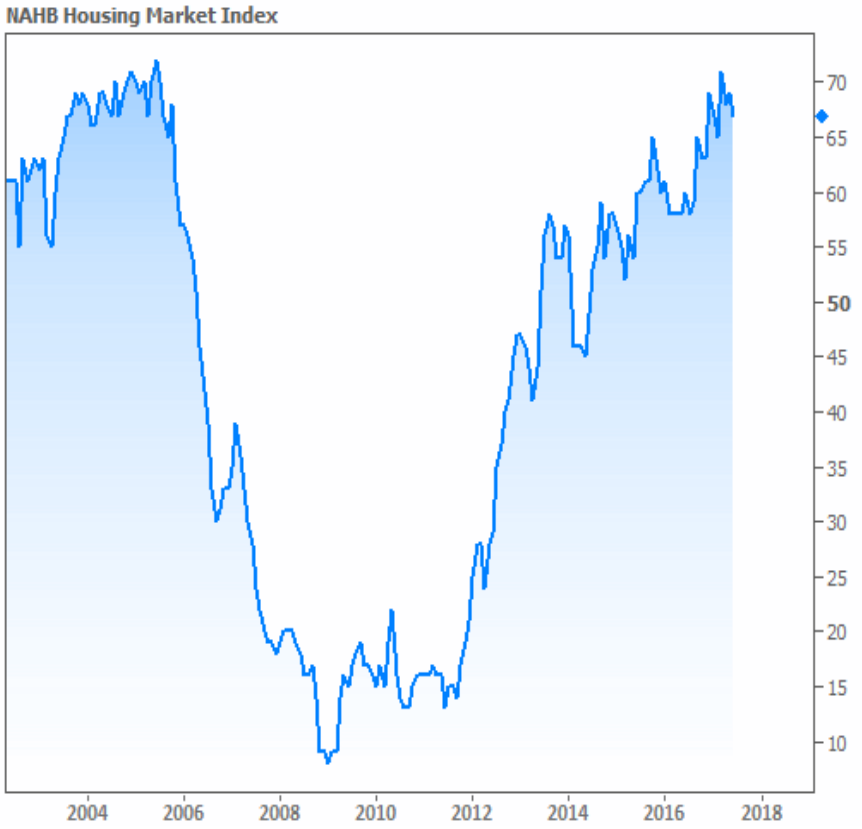


In housing-specific news, this week's economic data was generally **downbeat**. The National Association of Home Builders reported a drop in its Housing Market Index (a measure of builder confidence). In context, however, the index **doesn't** look like it's in trouble just yet.

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It's harder to offer a compelling counterpoint for Friday's New Residential Construction data from the Census Bureau. Both Housing Starts and Builder Permits came in well below forecasts, prompting National Association of Realtors' Chief Economist to say "housing shortages look to intensify and may well turn into a **housing emergency** if the discrepancy between housing demand and housing supply widens further."

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Recent Economic Data

Date	Event	Actual	Forecast	Prior
Monday, Jun 12				
11:30AM	3-Yr Note Auction (bl)	24		
Tuesday, Jun 13				
8:30AM	May Producer Prices (%)	0.0	0.0	0.5
8:30AM	May Core Producer Prices YY (%)	+2.1	2.0	1.9
Wednesday, Jun 14				
7:00AM	w/e Mortgage Market Index	442.6		430.6
7:00AM	w/e MBA Purchase Index	254.6		261.9
7:00AM	w/e Mortgage Refinance Index	1494.8		1368.7
8:30AM	May Retail sales mm (%)	-0.3	0.1	0.4
8:30AM	May Core CPI Year/Year (%)	+1.7	1.9	1.9

Event Importance:

No Stars = Insignificant
☆ Low
★ Moderate
★★ Important
★★ Very Important

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Date	Event	Actual	Forecast	Prior
8:30AM	May CPI mm, sa (%)	-0.1	0.0	0.2
10:00AM	Apr Business inventories mm (%)	-0.2	-0.2	0.2
10:30AM	w/e Crude Oil Inventory (ml)	-1.661	-2.739	3.295
2:00PM	N/A FOMC rate decision (%)	1.00-1.25	1.125	0.875
2:30PM	Yellen Press Conference			
Thursday, Jun 15				
8:30AM	May Import prices mm (%)	-0.3	-0.1	0.5
8:30AM	May Export prices mm (%)	-0.7	0.1	0.2
8:30AM	Jun Philly Fed Business Index	27.6	24.0	38.8
8:30AM	Jun NY Fed manufacturing	+19.8	4.00	-1.00
8:30AM	w/e Initial Jobless Claims (k)	237	240	245
9:15AM	May Industrial Production (%)	0.0	0.2	1.0
9:15AM	May Capacity Utilization (%)	76.6	76.7	76.7
10:00AM	Jun NAHB housing market indx	67	70	70
Friday, Jun 16				
8:30AM	May Housing starts number mm (ml)	1.092	1.215	1.172
8:30AM	May Building permits: number (ml)	1.168	1.250	1.228
10:00AM	Jun Consumer Sentiment Prelim	94.5	97.1	97.1
Wednesday, Jul 12				
1:00PM	10-yr Note Auction (bl)	20		
Thursday, Jul 13				
1:00PM	30-Yr Bond Auction (bl)	12		

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