Eric Aasness
Branch Sales Manager, Homebridge Financial
NMLS #506980
16040 Christensen Road, Suite 315 Tukwila, WA 98188

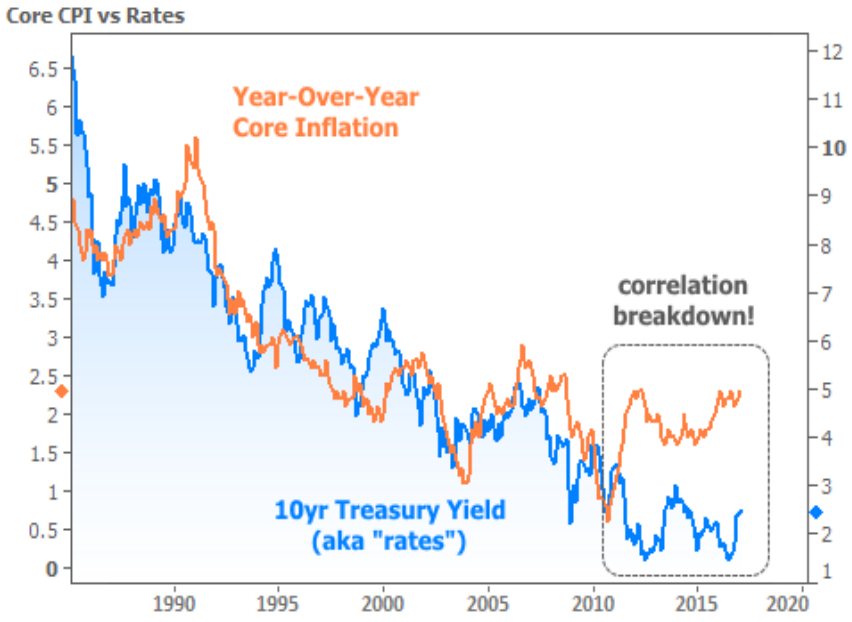
Mobile: 206-915-3742
eric@ericismybanker.com
View My Website

Inflation is Just One of Rates' Multiple Personalities

It used to be that higher inflation meant higher rates, **period**. That changed abruptly beginning in 2011. Inflation moved higher and rates plummeted. Many investors were puzzled at first, but most grew to accept the new reality. Now, that reality might be changing.

The breakdown in the long-standing correlation between rates and inflation is best viewed as a **hiatus** brought on by global financial panic and unconventional monetary policy. It's impossible to truly separate rates and inflation because higher inflation will always result in higher rates, **all other things being equal**.

When all other things **are not equal**, inflation's impact on rates can be **overshadowed**. From 2011-2016 it was vastly overshadowed!



During the time highlighted in the chart above, rates remained lower as global market turmoil and ongoing central bank stimulus drove demand for high quality government debt (higher demand = higher bond prices and lower rates).

As central banks continue trying to wind down their bond buying programs and the threat of a European market collapse subsides, inflation has **quickly** found its seat at the table. The US presidential election merely

National Average Mortgage Rates

Mortgage News Daily	Rate	Change	Points
30YR Fixed	7.27%	-0.02	0.00
15YR Fixed	6.92%	-0.03	0.00
30YR FHA	6.90%	-0.01	0.00
30YR Jumbo	7.55%	0.00	0.00
7/6 SOFR	6.78%	-0.10	0.00
30YR VA	6.91%	-0.01	0.00

Rates as of: 10/30

MBS and Treasury

	Price / Yield	Change
MBS UMBS 6.0	99.81	-0.02
10 YR Treasury	4.9299	+0.0084
30 YR Treasury	5.3082	+0.0081

Pricing as of: 10/30 5:59PM EST

Recent Housing Data

		Value	Change
Mortgage Apps	Oct 21	195	+3.39%
Building Permits	Sep	1.4M	+0.43%
Housing Starts	Sep	1.22M	-4.24%
New Home Sales	Sep	676K	-1.17%
Pending Home Sales	Aug	71.2	0%
Existing Home Sales	Oct	3.99M	+0.25%
Builder Confidence	Oct	29	-9.38%

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served as the dinner bell. It forced the question: what if growth and inflation increase from here?

If Trump's policies could indeed stimulate an already relatively healthy economy with official inflation figures running over 2% year-over-year, then long-term interest **rates had no business** being under 2%. Many investors quickly became concerned that a decades-long trend toward lower inflation and rates was at an end.

Those concerns are being compounded by their own implications. If inflation is indeed turning a corner, then the Fed **may need to hike rates** more quickly. Indeed the Fed said as much in December, and you can see the reaction in nominal rates (the non-inflation-related component of rates represented by the red line in the following chart).

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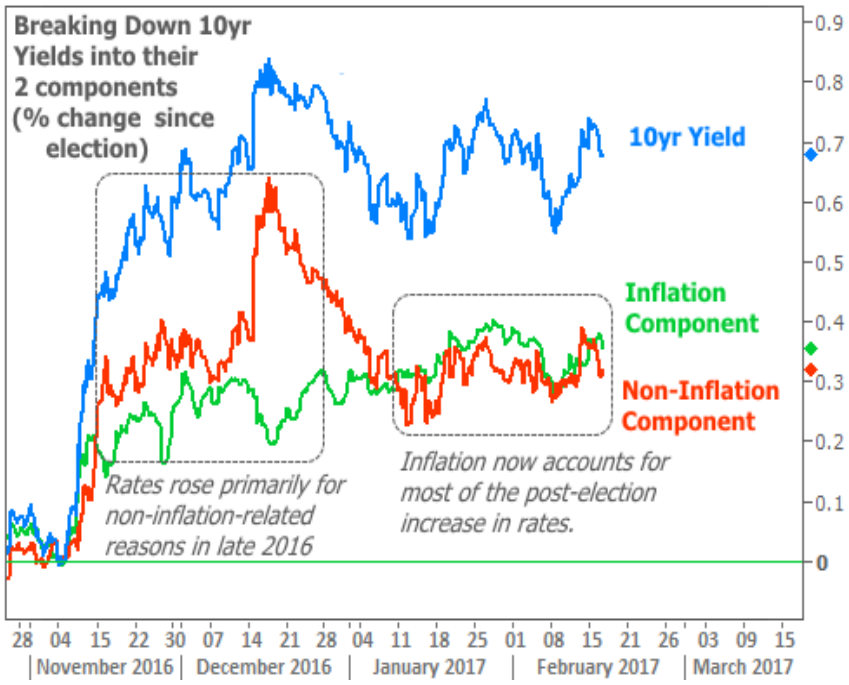
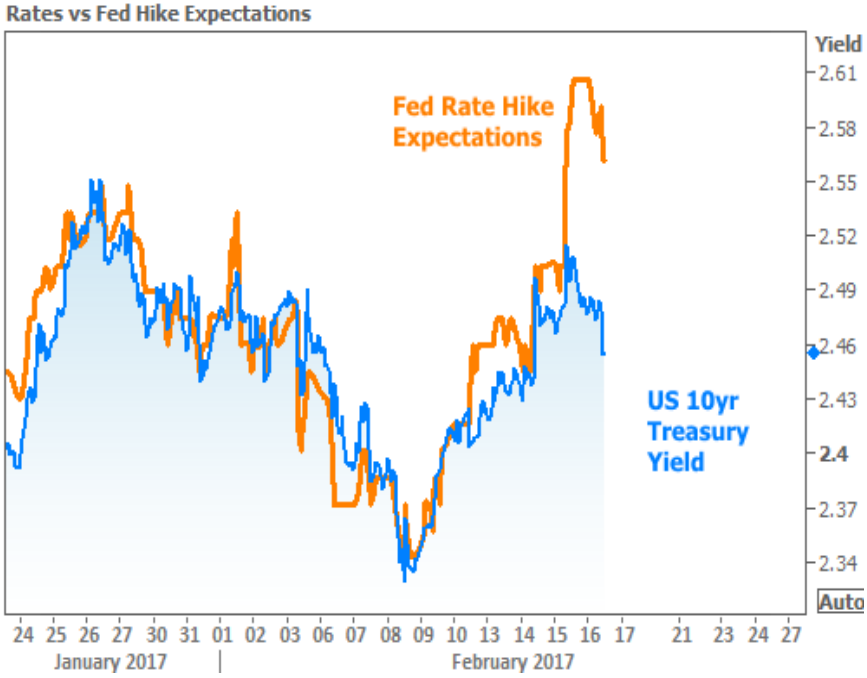


In the new year, nominal rates have pulled back somewhat (red line, above), but inflation expectations (the green line) remain elevated. **That's why rates have been sideways** for the past few months. They're waiting to see which of the two personalities will be in control going forward.

Trying to pick a winner is complicated because the two are so interconnected. We got **fresh evidence** of that this week when the Consumer Price Index--an inflation metric--rose more than expected. It led investors to increase bets on a Fed rate hike at the upcoming meeting, which in turn put some upward pressure on rates on Wednesday morning (the sharp spike in the orange line in the chart below).



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Beyond inflation and nominal rates, there's a popular misconception that stock prices drive interest rates. It's popular because **it's partially true!** The stock market is indeed a minor player in the bond market's multiple personality disorder, but this particular personality never gets full control. Correlation is easiest to see over the shortest time frames, and completely vanishes in the bigger picture.

In **housing-specific data** this week, Builder Sentiment pulled back slightly, but remained near post-crisis highs according to the NAHB's Housing Market Index.

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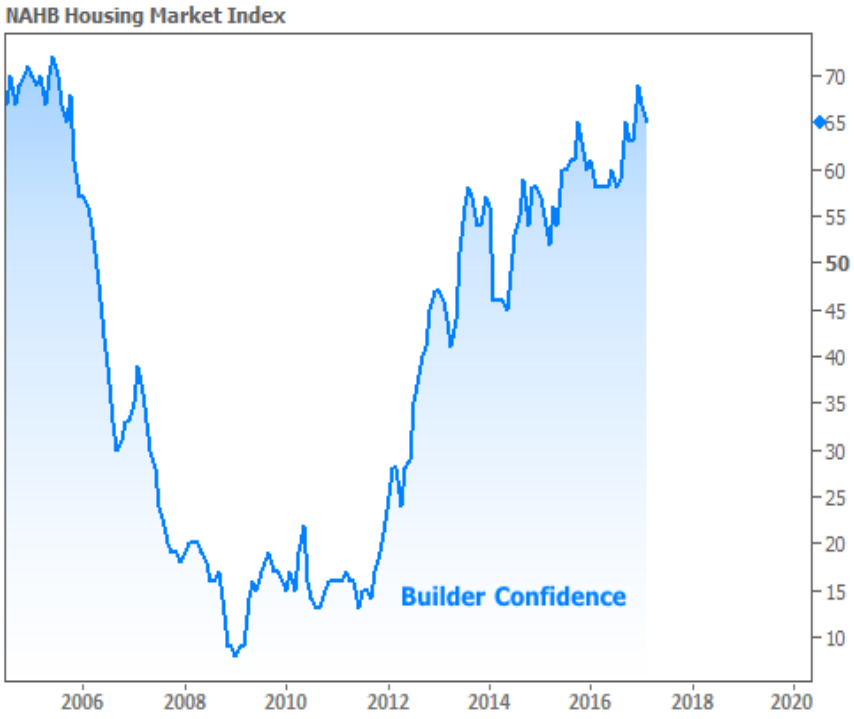
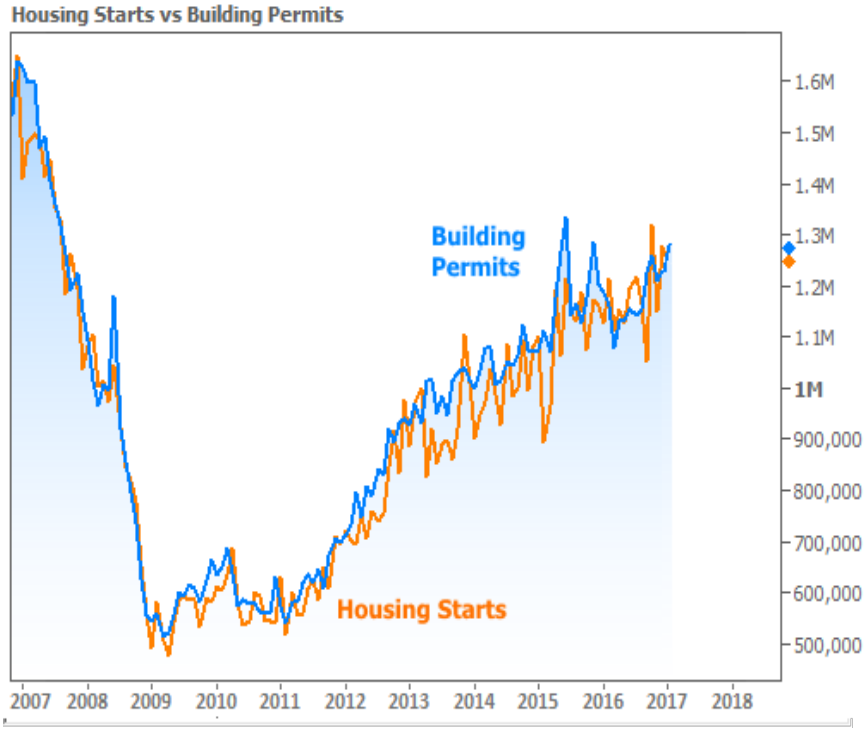


On a similar note, Housing Starts fell slightly but remained in strong shape overall. The same data showed Building Permits making some **encouraging gains**, hitting the best levels in more than a year.



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Recent Economic Data

Date	Event	Actual	Forecast	Prior
Tuesday, Feb 14				
8:30AM	Jan Producer Prices (%)	+0.6	0.3	0.2
8:30AM	Jan Core Producer Prices YY (%)	+1.2	1.1	1.6
10:00AM	Yellen Testimony before Senate Banking Committee			
Wednesday, Feb 15				
7:00AM	w/e Mortgage Market Index	379.0		393.6
7:00AM	w/e MBA Purchase Index	223.1		233.7
7:00AM	w/e Mortgage Refinance Index	1239.6		1276.4
8:30AM	Jan Retail sales mm (%)	+0.4	0.1	0.6
8:30AM	Jan CPI mm, sa (%)	+0.6	0.3	0.3
8:30AM	Jan Core CPI Year/Year (%)	+2.3	2.1	2.2
9:15AM	Jan Industrial Production (%)	-0.3	0.0	0.8
9:15AM	Jan Capacity Utilization (%)	75.3	75.5	75.5
10:00AM	Dec Business inventories mm (%)	+0.4	0.4	0.7
10:00AM	Feb NAHB housing market indx	65	67	67
Thursday, Feb 16				
8:30AM	Jan Housing starts number mm (ml)	1.246	1.222	1.226
8:30AM	Jan Building permits: number (ml)	1.285	1.230	1.228
8:30AM	Feb Philly Fed Business Index	43.3	18.0	23.6
8:30AM	w/e Initial Jobless Claims (k)	239	242	234
Monday, Feb 20				
12:00AM	Presidents Day			
Tuesday, Feb 21				
1:00PM	2-Yr Note Auction (bl)	26		
Wednesday, Feb 22				
10:00AM	Jan Existing home sales (ml)	5.69	5.54	5.49
1:00PM	5-Yr Note Auction (bl)	34		
Thursday, Feb 23				
9:00AM	Dec Monthly Home Price mm (%)	0.4		0.5
1:00PM	7-Yr Note Auction (bl)	28		
Friday, Feb 24				
10:00AM	Jan New home sales-units mm (ml)	0.555	0.570	0.536
10:00AM	Feb U Mich Sentiment Final (ip)	96.3	96.0	95.7

Event Importance:

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

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