Mortgage Broker's Best
Financing Your Future!

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Are Rates Doomed to Continue Higher?

After a calm summer at historic lows, interest rate volatility has ramped up heading into the fall. What are rates worried about, and is this just the beginning of more drama?

In a word: maybe!

Because they're based on bonds, rates are **always** worried about anything that can have a big impact on the supply/demand equation in the bond market.

Since March 2020, virtually any major supply/demand consideration can be traced back to the pandemic in some way. In general, as covid case counts drop, the **higher** the outlook is for rates, and vice versa.

MBS and Treasury

	Price / Yield	Change
MBS UMBS 6.0	100.22	+0.47
10 YR Treasury	4.8843	-0.0860
30 YR Treasury	5.2762	-0.0556

Pricing as of: 11/4 2:18PM EST

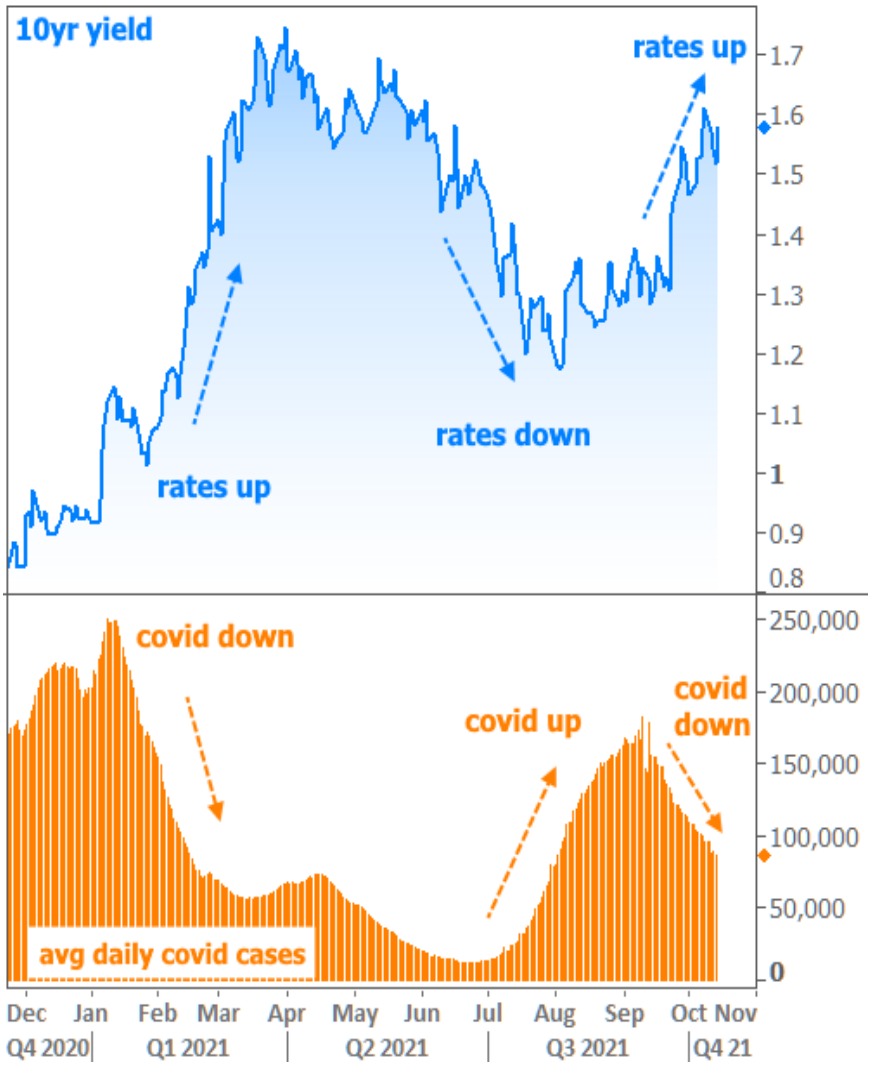
Recent Housing Data

		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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Rates have **other** concerns too.

Inflation is a constant consideration for bonds/rates because bonds are repaid on a fixed schedule that cannot adjust for inflation over time. If investors think inflation will move higher, they would demand higher and higher rates before buying bonds (in order to offset the loss of purchasing power due to higher inflation).

This can be a bit of an esoteric concept at first glance, but consider this simple example. If the price of "everything" is increasing at **4%** annually, would you purchase a bond that only pays you **3%** annually? Not if you had other investment options! Your lack of demand would contribute to bond sellers gradually lowering their prices (which, in the bond market, is the same thing as offering higher rates of return).

It just so happens that inflation is one of the most obvious places where covid has made a mess of things. The following chart shows one of the main inflation indices in the US (CPI). After the most recent update earlier this week, it remains reluctant to descend.

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We've all heard about **supply chain drama** and we've seen the debate about how permanent some of the price increases are likely to be. Markets debate that in their own way by trading different versions of US Treasuries that factor out future inflation fluctuations.

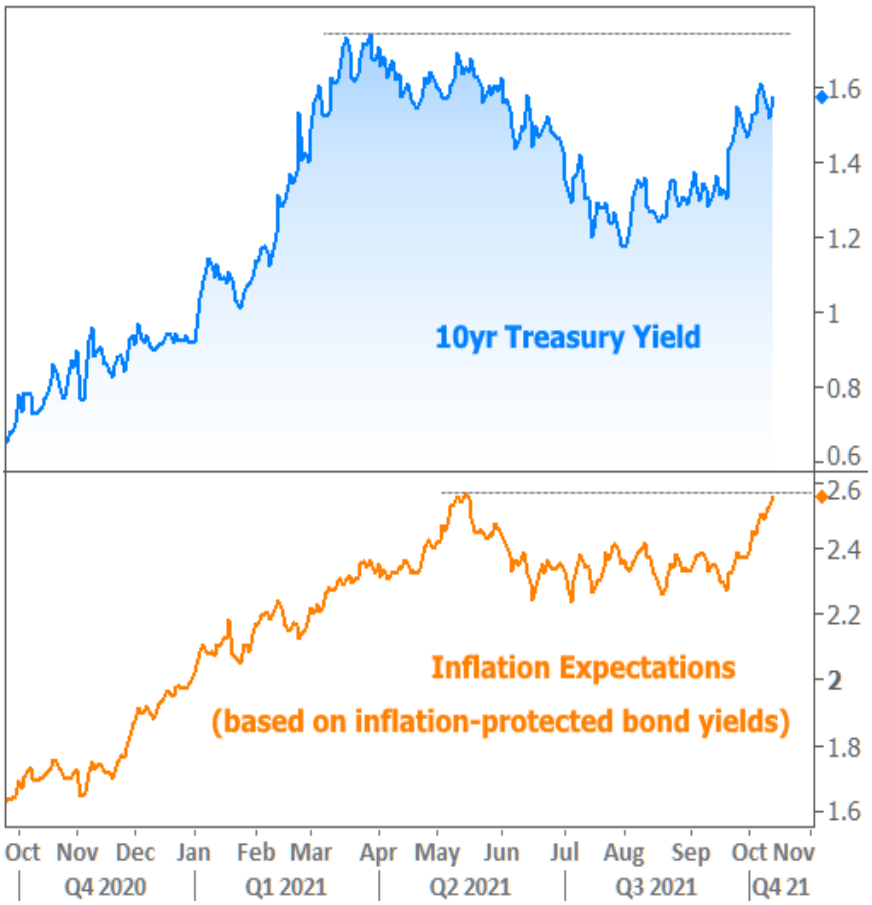
In other words, there's a **free market** to bet on how inflation will actually pan out. This is viewed as one of the more reliable inflation indicators, and it's definitely the most timely (big data reports are just now coming out for September while the market-based numbers are moving every minute of every day).

So how have they been moving? In a nutshell, inflation expectations (the orange line below) came off their highs in May and had been flat until just a few weeks ago. Since then, they've moved back up, ultimately matching **long-term highs** right at the end of the week.

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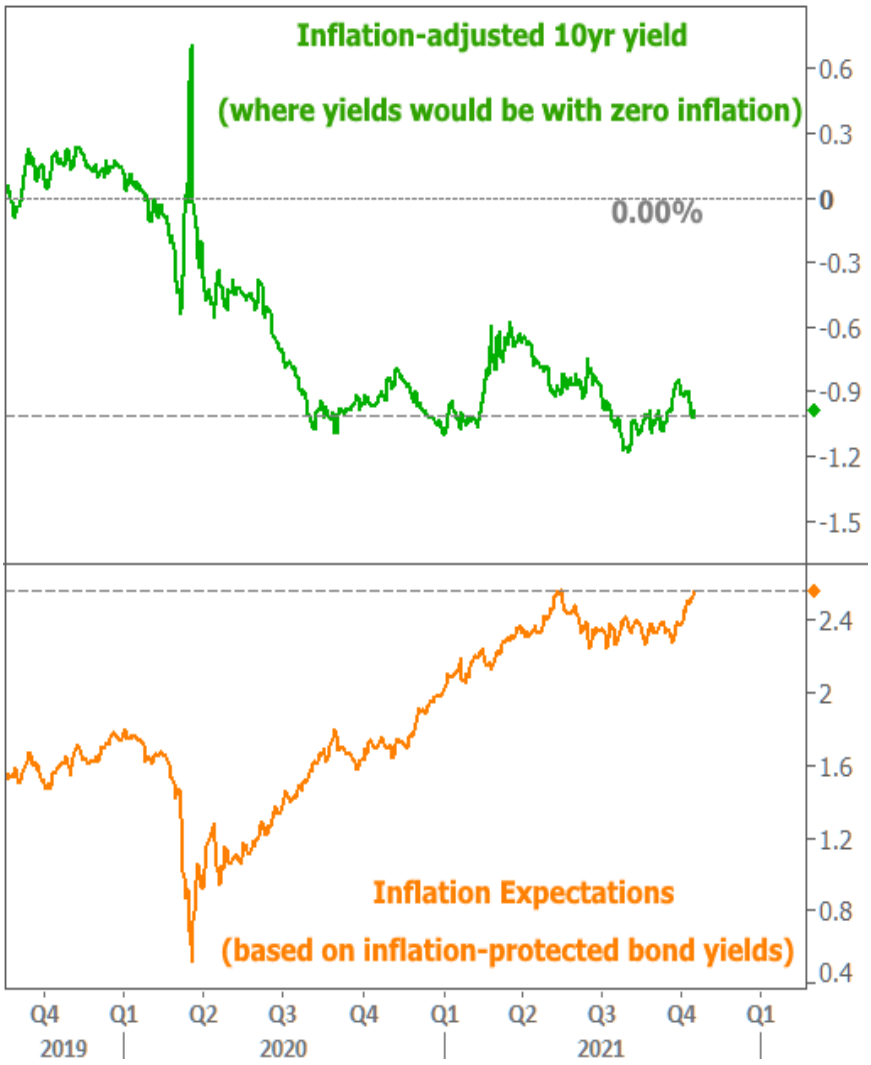


In the chart above, note that 10yr Treasury yields are **not** yet back to their recent highs. That means "real" rates (those that factor out the inflation) will be lower, but how much lower? The answer is a bit **surprising** and it's seen in the green line in the following chart (the orange line from the previous chart is also included for reference).

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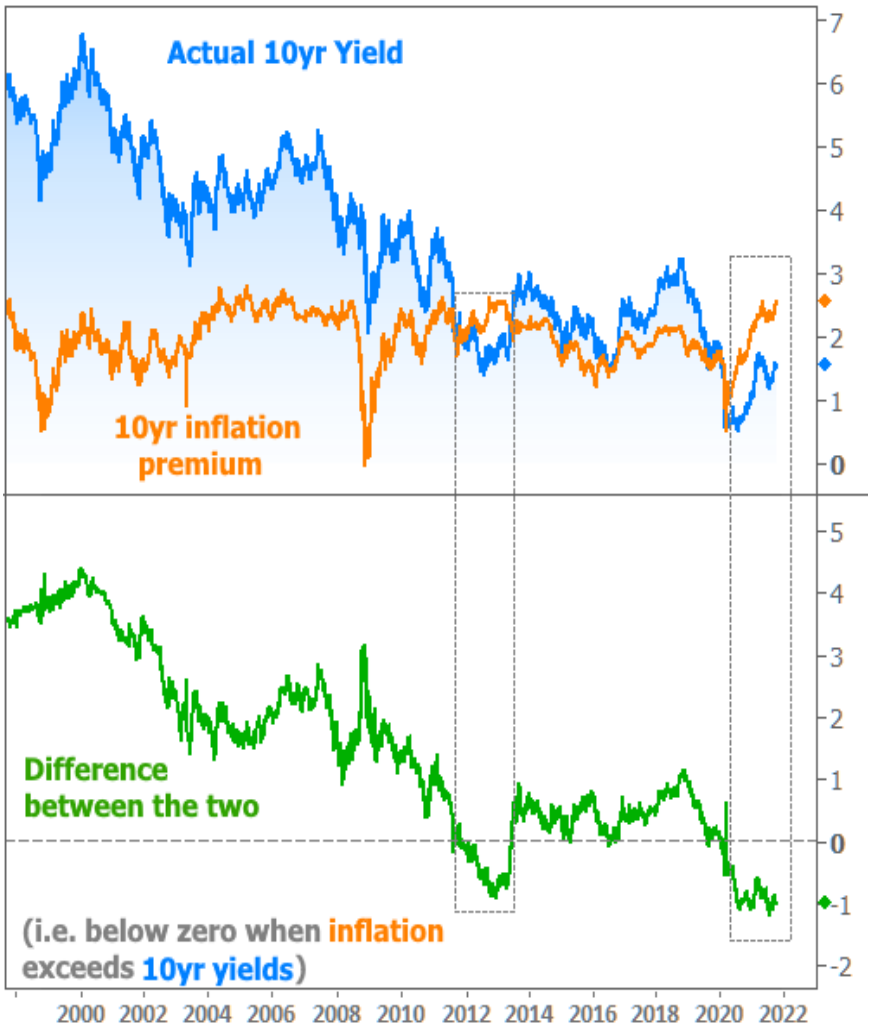


And here's the bigger-picture context, with 10yr yields in blue, inflation expectations in orange, and the difference between the two (inflation-protected yield) in green. Note: the green line dips below zero when the blue line dips below the orange line.

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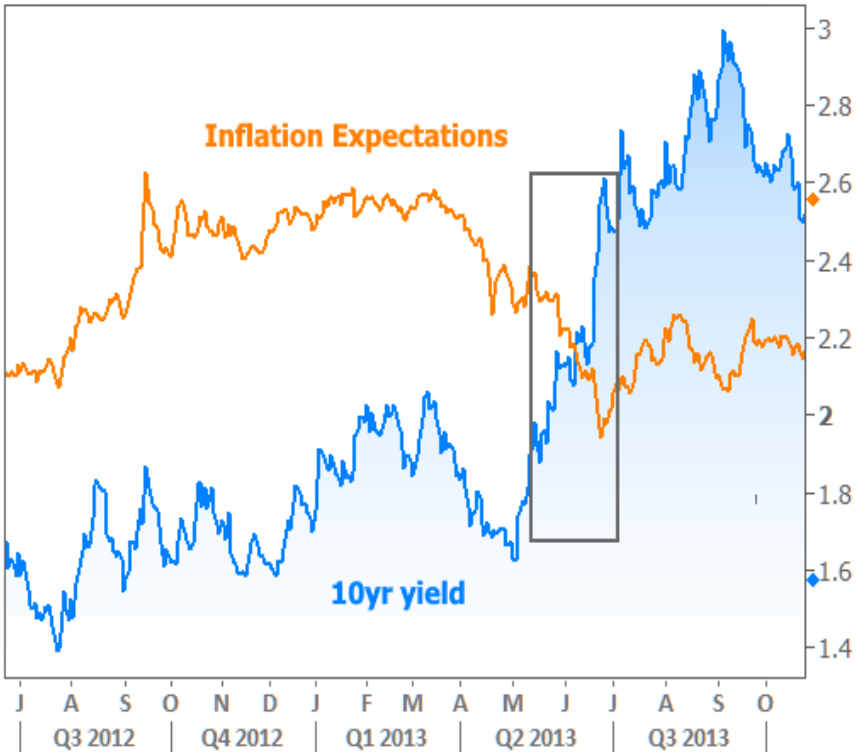
Translation: if it weren't for the inflation surge, **rates would be very close to all-time lows.** For those of you thinking three steps ahead: yes, there is a bit of an interdependency here because higher inflation is seen as a brake on the economy (and economic strength pushes rates higher), but the point is that rates would certainly be a bit lower than they are now.

There is **hope** and **caution** here. On one hand, we could hope to see inflation subside, thus allowing rates to calm down. On the other hand, there are times where inflation is falling while rates are rising. The middle of 2013 was a relevant example.

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Why was 2013 relevant? That's the last time the Federal Reserve indicated it would begin reducing the pace of its massive bond buying program (i.e. "**tapering**"). If you've heard of the "taper tantrum," that was ground zero.

The Fed will begin to taper its current bond buying efforts shortly and they'll almost certainly announce that in **November**. Does that mean rates are **doomed** by yet another fate? Yes and no. We'll examine this in greater detail next time, but here's a sneak preview.

The following chart shows the Fed's 3 major stints of bond buying in the past (officially "quantitative easing" or "QE"). It's common practice to credit Fed bond buying for ultra low rates--so common that people are invariably **shocked** when they see that rates actually rise fairly reliably during the time that the Fed is buying, and that they begin falling even more reliably after the Fed is done buying.

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Of course the current environment may not play by the same rules, but if it does, the best thing that could happen for rates would be for the Fed to taper quickly and completely.

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