



The Expert's Guide to Mortgage Interest Rates

Whether you're buying a new home or refinancing your existing home, you're about to make some critical decisions about mortgage interest rates. This guide will give you an expert's insight to the most commonly asked questions.

Gaining even a basic understanding of the role of interest rate movements, lock options, and strategies can save you tens of thousands of dollars in interest over the life of your new loan and help guarantee your mortgage application process is easy and pleasurable.

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The subject of *mortgage interest rates and points* has traditionally been a source of considerable stress for uneducated borrowers. But it needn't be stressful at all if you understand a few simple basics:

- **Rates Change Daily**
And in many cases hourly. Yesterday's quote is very likely to be different than today's, and today's different than tomorrow's. If you can't afford a rate increase, then lock in your interest rate and points as soon as you've completed your loan application.
- **Don't Play the Guessing Game**
Nobody, and we mean *nobody*, has the power to accurately predict when, and in which direction, interest rates will move. If a lender tries to tell you otherwise, it's a good indicator that it's time to find a more honest or knowledgeable lender.
- **Getting the *Right* Rate and Point Combination**
Determining which combination of rates and points is best for you is generally a function of how long you intend to keep the mortgage. In general, the longer you plan to keep the mortgage, the more advantageous it is for you to get a lower rate by paying more points.

Now, if you really want a more in-depth understanding of the factors that affect interest rates on a daily basis, read the following section entitled *What Makes Mortgage Interest Rates Rise and Fall?*

Read it carefully. The information presented in it will help you to better understand the mortgage lending process and will help you save both time and money.

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What Makes Mortgage Interest Rates Rise and Fall?

The questions are simple enough: What's going on with mortgage rates?

What makes them rise, or fall? Is it the Federal Reserve (“the Fed”)? The economy? Inflation? The President? Fannie Mae or Freddie Mac?

The answer is that rates are moved by a number of related factors, and believe it or not, *you* are one of those factors.

Mortgage money can come from many sources, including deposits at banks and brokerages, but most comes from investors through what is collectively known as the “capital markets.” This is where investors interested in purchasing certain kinds of debt instruments—bonds, in this case—come to buy these items.

In order to attract investors, sellers of bonds must compete with one another to get their money. They do this by offering a variety of “instruments” (also referred to as “product”) with differing structures of risk and return over given periods of time. These offerings compete with other investments that are reasonably similar in performance, such as US Treasuries, corporate bonds, foreign bonds, and others.

Who are these investors, and why are they so fickle? Mostly, they are people like you, and they want two opposing things: low payments on your debts (especially your mortgage), and high returns on your investments. You (or your investment advisor or fund manager) will only buy so many low-yield bonds (mortgage or otherwise), because you'll take your money elsewhere if your returns are too low.

Investor demands for a given kind of investment plays a considerable role in moving market yields, because investors have literally hundreds of places to put their money. It's a crowded marketplace, with many sellers of various products competing for those investment dollars. Investor demands for a specific product rises and falls with changes in investment strategies: if demand falls enough, a change needs to be made to attract investor again. How is this done? Usually, by raising interest rates.

Of course, it's not as easy or simple as that. Mortgage markets serve not just one client, but rather two: investors, who want the highest possible return on their investments, and the homeowner, who want the lowest possible interest rate. Simultaneously, rates need to be high enough to attract investors, but low enough to attract borrowers. As you can imagine, it's quite a complex dance.

As interest rates (yields) decline, investment customers can become either more or less interested depending upon the direction of economic growth, inflation, demand for the given product, and a number of other factors. Typically, though, the lower that rate gets, the fewer interested investors there are interested in putting them on their books.

In the case of financial instruments like bonds, things get a little more complicated. Bonds have an interest rate (yield), a dollar amount (face), and a current price (price).

A simplified explanation might be as follows:

Let's suppose, for example, that you want to sell a \$1,000 (face) bond with a yield of 6%. And let's say that it's a good deal, so ten investors start offering you more than the \$1,000 that you originally requested. They bid the price up to \$1,010—\$1,020—\$1,030. In effect, that increase in price is actually borrowing from the interest that the bond will return. Because some of the interest is now effectively gone, the actual return to the investor is no longer 6%, but rather something less than that. When demand for a given bond is strong, prices rise to the seller, and return to the investor (yield) declines.

Conversely, when demand for a given bond is weak, the price falls. For example, one might have to sell that \$1,000 bond for only \$980; and the return to the investor (yield) rises, since the borrower not only gets all of the 6% interest on the \$1,000, but also got a discount on its purchase price.

The principle to remember is this: as a bond's price rises, it's yield falls, and vice-versa.

Relationships to Other Investments

Mortgages are priced for sale to attract investors who seek fixed-income investments. There are many kinds of bonds available, and mortgage rates (yields) affected by those competing investments.

But how to price them? Fixed mortgage rates, like other bonds, track US Treasury bonds quite well. Since Treasury obligations are backed by the “full faith and credit” of the United States, they are the benchmark for many other bonds.

There is no “lock-step” relationship between Treasuries of any term and fixed mortgage rates. Given enough data points, a relationship could be established against many different financial instruments. However, as a 30-year fixed rate mortgage rarely last more than 10 years before being paid off or refinanced, the closest instruments possessing similar (though less) risk, is the 10-year Treasury Constant Maturity. This makes the 10-year Treasury an excellent tool to track mortgage rates.

Here’s an oversimplification of the relationship of mortgages and Treasuries:

As we mentioned, intermediate-term bonds and long-term mortgages (more properly referred to as Mortgage-Backed Securities, or MBS) compete for the same fixed-rate income dollars. Treasury issues are 100% guaranteed re-paid, but mortgages are not; therefore mortgages carry more risk of default or early repayment, which can diminish its return on investment. Consequentially, mortgage rates may be priced higher to compensate for the greater risk.

But how much higher are mortgages priced? In the current market, the “spread” or markup above the 100% secure Treasury is about 200 basis points (2%). That markup—the spread relationship—expands and contracts as market conditions, investor demand, and competing investment products change. Professional money-managers and investment and retirement funds constantly strive to obtain high-yielding instruments at relatively minimal risk. As such, money is constantly shuffling from place to place in search of this—from bond to bond, and market to market.

As mentioned, the relationship isn't static, but rather changes constantly with ever-evolving market conditions. Therefore, one can never accurately determine current mortgage rates by adding 2% to the ten-year yield.

Other Factors

There is also the “unknown supply stream”, aka “volume”. Unlike many other investments opportunities, no one really knows how many mortgages will be originated, and then made available for sales as bonds in a given period of time. Recently, quick drops in interest rates produced a large buildup of loans to be sold to investors as homeowners rushed to refinance. This created way too much bond supply available in too short a time, and investors simply couldn't absorb it all at once. Too much supply, not enough demand; prices had to go down and yields had to go up to attract investors.

Delays, Delays

There also exists a time-lag for mortgage pricing. Though shorter than in years past, it takes anywhere from several hours to several days for changes in the capital markets to be reflected in the “street” price of mortgage lending rates.

Not all increases or decreases are passed along, either. Depending upon the size of the change, rates may actually stay the same, as smaller price adjustments are often reflected in the discount points and fees associated with originating the loan. Sometimes, a minor increase in bond yields in the morning is followed by a minor decrease in the afternoon, while mortgage rates remain the same all day long.

Other Risks

There is also the risk of inflation, which affects Treasury, mortgage, and other fixed-income investments. Rising inflation reduces the actual return on a fixed rate investment, so with 2% inflation, our hypothetical 6% mortgage note only returns 4% “real” interest.

If the rate of inflation is expected to decrease for the foreseeable future, you can bet that mortgage rates have some room to fall. Conversely, an

outlook that suggests higher inflation ahead will see mortgage rates rise, sometimes very quickly.

Also, a poor economic climate affects mortgage rates much more profoundly than Treasuries. After all, the US government isn't likely to lose its job and suddenly stop making payments, but it's a safe bet that a percentage of homeowners will, even in good economic times.

There's much more to the structure of bond, mortgage, and capital markets, including government influences and overseas relationships to our capital markets that can also have an effect, but the information provided above should be enough to provide you with a modest working knowledge of the market. You will notice, up to this point, we really haven't mentioned the Federal Reserve Board (the Fed) at all. Fed policy and rate movements have no *direct* effect on fixed rate mortgage pricing, but their action or inaction (and expectations thereof) can have a substantial indirect effect.

The Fed's Role

Contrary to popular belief, the Federal Reserve Board doesn't control mortgage rates. In fact, their most well known policy tool—the Federal Funds Rate—is the overnight interest rate that banks can charge each other when a bank needs to borrow money to meet its end-of-day reserve requirements. Simply, those rules require that a bank must have a certain amount of cash on hand at the end of each day, and those funds can be borrowed from another bank at this interest rate. You should know that the Fed merely “suggests” what this rate should be, which is why it's called a “target” rate; the actual rate is negotiated between the borrower bank and the lender bank.

A good way to keep a handle on the Fed is to remember that the Fed Funds Rate is the shortest of short-term rates—literally, for an overnight loan—and a fixed rate mortgage loan is all the way at the other end of the scale, a loan that lasts as long as 30 years.

From Fed Funds Rate adjustments, begins a complicated discussion of monetary policy about how Fed movements affect certain deposits, loan markets, and inflationary expectations. The end result is that the Fed raises or lowers the Fed Funds Rate to help manage increases or decreases

in economic activity. Lower rates can help banks make certain kinds of loans more cheaply, especially for businesses and certain kinds of consumer lending, and that can help generate greater economic growth. Higher rates, by contrast, can reduce demand, and thereby reduce inflationary pressure.

In some ways, the mere expectation of what the Fed might do can be more important than what it actually does, as their actions or inactions can help to confirm or deny what investors believe about the current state of the economy and capital markets.

You may have noticed that sometimes the Fed reduces the Fed Funds Rate and fixed mortgage rates actually increase as a result. Why? If the Fed is taking steps to address economic weakness by lowering the Fed Funds Rate, it likely means that a return to faster growth—and possible higher inflation, as well—is coming sooner rather than later.

So, what moves mortgage rates? Supply. Demand. Competition for money. Inflation. The economy. Expectations. And, of course, you.