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Fed Quiet Could Mean Mortgage-Rate Rise

Less guidance and more volatility can add a premium to bonds backed by home loans

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The mortgage market hangs on every word that comes out of the Federal Reserve. So what happens when the Fed says a lot less?

At his first news conference as Fed chairman, Kevin Warsh suggested that he wants the market to tell the Fed what it thinks interest rates should be—and not the other way around. The Fed didn't provide forward guidance in its first policy statement under Warsh. He declined to contribute rate projections alongside other Fed officials. And when asked by reporters, Warsh didn't elaborate on what he thought about those officials' quarterly rate projections showing higher future rates. — Note

"When all the financial markets are doing is reflecting back what we've said, then we're taking the most important source of information and we're being blind to it," Warsh told reporters.

— Note

But when markets are left to their own devices, another upshot could be more volatility in the bond markets, as traders and investors hash out their divergent views. And that in turn might mean higher rates as investors demand compensation for the uncertainty.

"In general, this likely means less anchoring of expectations, more volatility in front-end rates, and a higher probability of policy surprises in either direction," Pimco economist Tiffany Wilding wrote last week. "Without the Fed as a perceived steady anchor, risk premiums across asset classes may need to increase."

Investors may not mind earning higher yields. But borrowers will mind paying them. And among the borrowing costs most sensitive to interest-rate volatility are mortgage loans that are packaged into bonds known as mortgage-backed securities.

— Note

Interest rate risk is the main risk to investors associated with "agency" mortgage bonds backed by Fannie Mae and Freddie Mac, because they are guaranteed against credit losses. Changes in mortgage rates can make a borrower more or less likely to refinance, altering the projected duration of the loan's payouts to investors.

So when there is more volatility, potentially driven by uncertainty about the future path of rates, investors typically demand even more of a premium to own these bonds over government debt.

Bond-market volatility often leads investors to demand more of a premium to own them over Treasurys. KYLE GRILLOT/ BLOOMBERG NEWS

Middle East has calmed expectations for an immediate rate increase. But investors expect higher rates further out. Markets are currently pricing in a roughly 30% chance of a quarterpoint rate increase at the Fed's next meeting in July, but a 77% chance of one or more hikes by the end of year, according to CME FedWatch.

Short-term 2-year Treasury yields jumped after the Fed meeting, despite Warsh declining to give any formal indication that officials' projections would influence the next decision. But measures of rate volatility, such as the ICE BofA Move index, haven't changed much. Note

A daily measure of 30-year fixed mortgage rates by Mortgage News Daily also ticked higher in the days following the meeting, going from 6.52% to as high as 6.66%. But that rate then drifted back lower.

Over time, attention is likely to turn from oil markets to the debate over the impact of the AI boom on prices. The Fed's

The prices on these bonds flow through to mortgage rates. This causal chain is why brokers and real-estate agents often invoke future Fed moves to try to spur their clients into action.

"Mortgage rates are among the most interest-rate sensitive parts of the economy," says Joseph Brusuelas, chief economist at RSM. "And interest-rate expectations play a huge role."

For the moment, the pause in hostilities in the views on this and other fundamental questions, however, are very much up in the air at the moment. That is because Warsh is in the process of setting up task forces to examine topics such as productivity in the labor force and the reliability of economic data, the findings of which he will likely report on by year-end.

Note

Regardless of how it communicates, the Fed has its monetary policy tools to move short-term interest rates. Its role in setting longer- term rates is often more indirect, especially if the Fed continues to shrink its balance sheet and holdings of bonds—something Warsh has advocated in the past, and another subject that a task force will examine for him.

Any real-estate agent knows that nervous home buyers often need a lot of reassurance. They, and the broader mortgage market, are about to get less of it.

—Telis Demos