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Mortgage rates could drop as treasury yields fall

Although mortgage rates are influenced by the federal funds rate, they are more strongly tied to the 10-year treasury yield.

Lenders use the treasury yield as a benchmark for mortgage rates to keep mortgage-backed securities competitive with treasury bonds.

Secretary of the Treasury Scott Bessent has publicly announced the Trump Administration's commitment to bringing down the treasury yield to provide housing relief, and Morgan Stanley analysts believe that will happen in the next two years.

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In a new report, the investment bank wrote, "The good news is: Morgan Stanley strategists anticipate that mortgage rates could fall with Treasury yields over the next two years and home prices may decrease slightly amid increased housing supply."

However, the treasury yield drops during economic uncertainty, as bond demand and prices rise when investors flock to 'safe' investments. If mortgage rates fall due to an economic downturn, it may be difficult for housing activity to revert to previous levels.

A housing revival may be the key to GDP growth

If mortgage rates do continue to fall through 2026 without a recession, increased homebuying could help stimulate the U.S. economy through GDP and consumer spending.

The National Association of Home Builders (NAHB) found that consistent mortgage rate declines in early 2025 raised homebuyer confidence enough to increase housing sales.

Related: Fannie Mae makes crucial update to 2025 mortgage rate forecast

Increased housing sales will not only create a hotter housing market but will likely increase economic activity. Morgan Stanley predicts consumer spending and residential investment will rise as lower mortgage rates reinvigorate the housing market.

"Housing flows into gross domestic product (GDP) not only through residential investment, but also through the impacts on consumption," Morgan Stanley economist Heather Berger said. "Households spend more on durable goods following home purchases."

U.S. Real GDP growth dropped 0.3% during Q1 2025, largely as a result of lower imports from reciprocal tariffs announced by the Trump Administration. Housing-related economic growth may become increasingly important as the full effects of U.S. trade wars are realized.