

WSJ Print Edition

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Mortgage rates have been falling in anticipation of the Fed's rate cut. ZACK WITTMAN FOR WSJ

Where Mortgage Rates Go From Here

While the Fed has begun cutting rates again, there are many other factors that affect the cost of home loans

With the Federal Reserve in cutting mode, many people expect mortgage rates to fall fast. Unfortunately, it isn't that simple.

The Fed sets a target for a shortterm, overnight interest rate. Lots of other borrowing rates are priced off that baseline. But mortgages aren't one of them.

Instead, a key benchmark for mortgages is the yield on 10-year U.S. Treasuries, since that is about the expected amount of time a homeowner might hold a 30-year mortgage before moving or refinancing. The yield on those notes helps determine the price investors pay for bonds that pool many individual mortgages.

True, the Fed can influence the yield on that longer-dated paper through its current short-term rate policy, economic projections and jawboning. Longer-term Treasury yields and mortgage rates had been falling in anticipation of the Fed's move Wednesday to cut rates by a quarter of a percentage point.

Even so, how things play out in the longer term is ultimately in the hands of investors.

And they might not want to lower their demands for yield over a number of years because there is another crucial thing they have to consider: inflation.

Regardless of what investors think the Fed might do with rates in the near future, investors are also worried that being paid a fixed rate on today's investment isn't going to be enough to keep up with inflation. The risk is that the same interest payment years from now might buy a lot less.

This can lead to confounding moves. A year ago, for example, the Fed surprised markets by lowering its benchmark rate by half a percentage point at its September meeting. During the next two months, the 10-year Treasury yield rose by about a half percentage point and average mortgage rates jumped about three-quarters of a point. Note

That isn't to say markets in coming months will respond to the Fed's latest move in the same way. Perhaps the current feeling is that inflation is mostly under control and the bigger risk is job losses due to a slowing economy. In that case, lower rates might not put as much upward pressure on prices, causing inflation fears to recede.

That, in turn, could lead to lower mortgage rates, revived home-buying activity and more housing supply that helps keep home prices in check.

But investors who buy mortgages, corporate debt or U.S. Treasuries that last for years and years are thinking way beyond what will happen at the Fed's next meeting. Note

The result is that, historically speaking, changes in the Fed's benchmark rate targets "barely are correlated" with changes in home-borrowing costs, according to strategists at Morgan Stanley, who compared prior changes in Fed-rate policy to changes in mortgage rates.

"We would argue that if the Fed simply does what the market expects, mortgage rates will not fall materially," the strategists wrote in a recent note. Note

The Fed isn't powerless, how--ever. Home buyers and investors can't ignore the politics currently swirling around the central bank. In theory, this means a future Fed might give priority to aims such as promoting the housing market via lower home-borrowing rates.

It is within the Fed's tool kit, for example, to buy mortgage bonds, one variety of a maneuver known as "quantitative easing." Note

Following the 2008 financial crisis, for instance, the Fed began purchasing Treasuries and mortgage bonds. One reason cited was to restart the crashed housing market to help improve overall financial stability.

"Lower mortgage rates should support the housing sector," then-Chair Ben Bernanke said in a speech in early 2009.

There are potential risks, though, to pursuing such policies outside of a crisis. Although the Fed has enormous firepower, expanding its balance sheet wildly could stoke inflation. Even the prospect of that could cause Treasury yields to surge and disrupt other markets.

In that case, Fed efforts to control the long end of the yield curve could backfire.

The Fed could also take more moderate steps. When it began aggressively raising interest rates in 2022, the Fed also said it would start letting its mortgage-bond portfolio shrink. That is one reason the Fed's ability to lower mortgage rates via short-term rates has been curtailed in recent years. Note

The Fed could reverse that decision, as some have suggested, and keep its holdings of agency mortgage-backed securities, or MBS, steady. That could support mortgage-bond prices and, in turn, put pressure on mortgage rates to fall. Note

"What if the Fed simply stopped shrinking its MBS holdings?" Pimco portfolio managers Marc Seidner and Pramol Dhawan wrote in a note this week. "In a cycle where interest rate policy is politically fraught and inflation remains sticky, the Fed may find that the most effective easing tool is already hiding in plain sight."

The bottom line for home buyers and investors is that the coming direction of mortgage rates is subject to a host of varied and unpredictable forces. The Fed is just one of them. side