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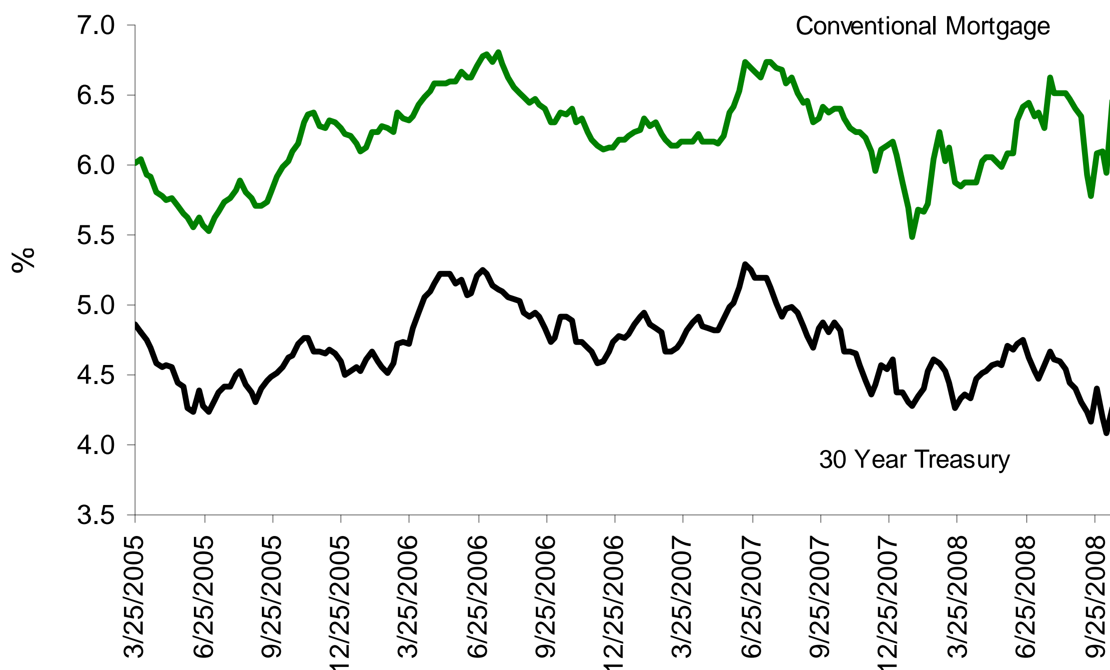
Mortgage Rates Going Up, Not Down

Mortgage rates have been going higher, not lower, despite increasing government control of the mortgage market.

- Lower mortgage rates are a necessary step in stabilizing the housing market and are now within federal control.
- The spread between the Fannie Mae bond yield and Treasuries remains particularly wide. Mortgage rates may also be high due to disarray and weakened staffing at Fannie Mae and Freddie Mac surrounding the government takeover. While Treasury Secretary Paulson has requested more activity at the GSEs, it's not clear they are up to it yet.
- We think Treasury will focus on this when time permits and will succeed in bringing mortgage rates down substantially, contributing to a stabilization of the housing market in 2009.

Conventional 30 Year Mortgage Rates and 30 yr US Treasury Yield (last obs. October 20, 2008)



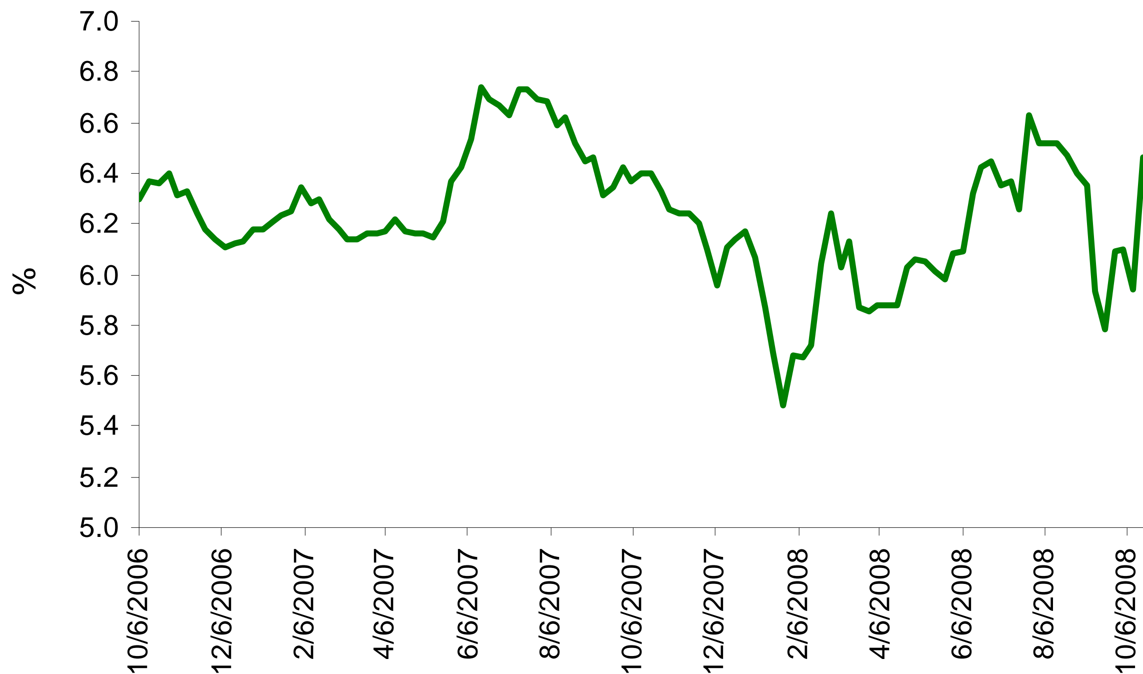
Source: Haver; Encima Global

- Contributing to the current recession, mortgage rates increased in the second quarter even though Washington encouraged Fannie Mae and Freddie Mac to lend more, lifted restraints on their balance sheets, and increased the size limit for conforming mortgages.

- Mortgage rates are rising again in the fourth quarter even though the government took over Fannie Mae and Freddie Mac in September.

- The yield on the 30-year fixed rate conforming mortgage has risen to 6.5% in recent days, versus 4.2% for 30-year Treasuries, 5.1% for Fannie 30-year debt and a 5.4% yield for Fannie MBS (up from 5.3% a few days ago).

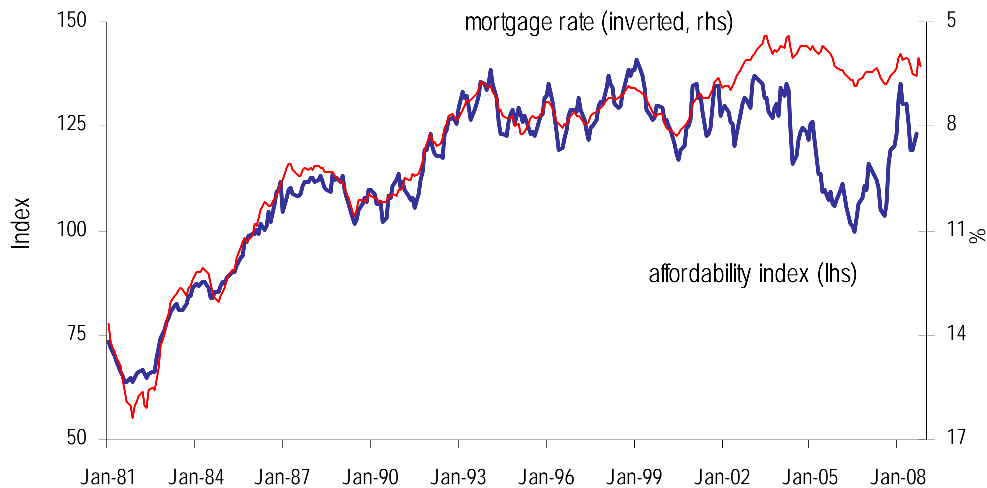
Conforming 30 Year Mortgage Rate (last obs. October 20, 2008)



Source: Haver; Encima Global

* Mortgage rates have been a key factor in housing affordability in recent decades. The relationship broke down in 2005-2007 when affordability declined due to high house prices and weaker income growth. Affordability has improved this year due to declining house prices, and would improve further if mortgage rates declined.

Housing Affordability Index (last obs. August 2008)



Source: Haver; Encima Global

Several factors argue for a lower mortgage rate

* Treasury yields are low. The 30-year yield is at only 4.2% and fell below 4% on October 6. The Fed cut the Fed funds rate to 1.5% on October 8.

* On October 14, Treasury Secretary Paulson called on banks to lend more aggressively. On September 19, Secretary Paulson instructed Fannie Mae and Freddie Mac to support the mortgage market: "To provide critical additional funding to our mortgage markets, the GSEs Fannie Mae and Freddie Mac will increase their purchases of mortgage-backed securities (MBS). These two enterprises must carry out their mission to support the mortgage market."

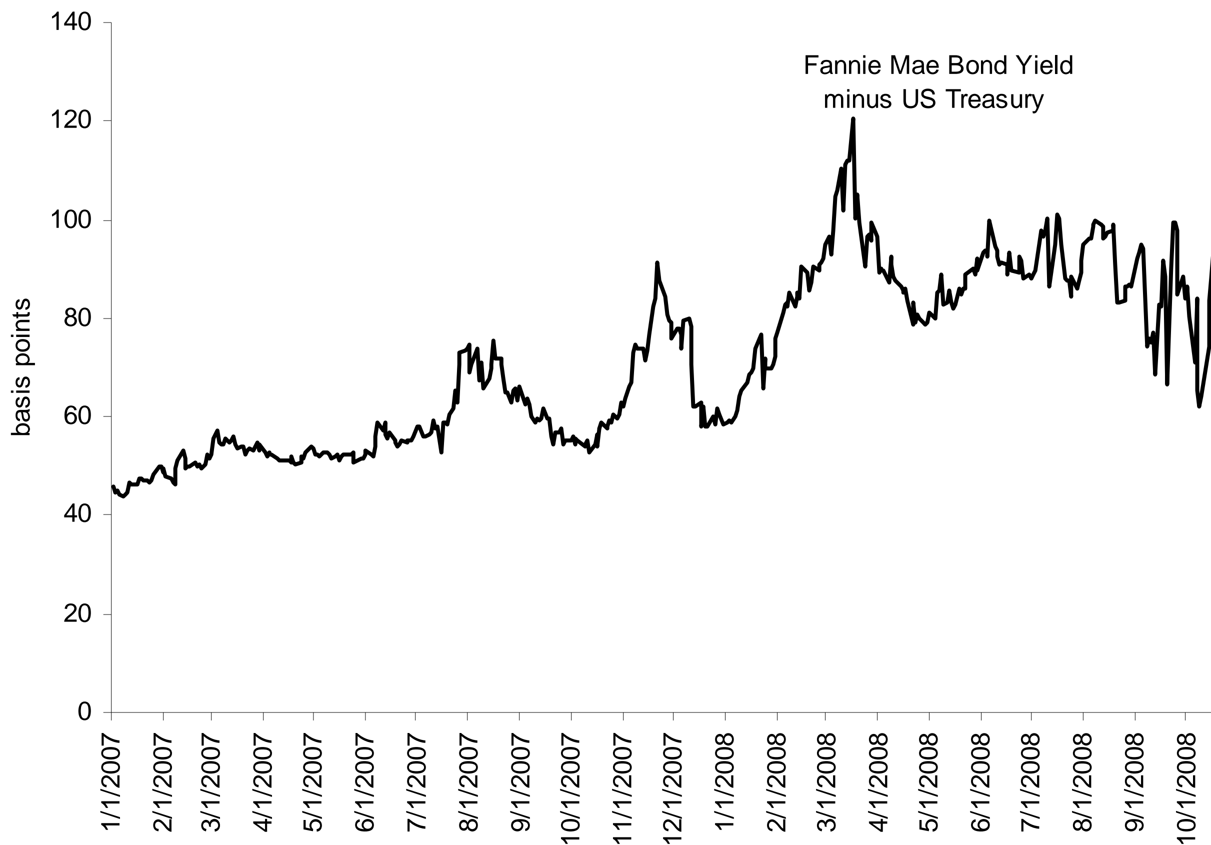
* The federal government now controls Fannie Mae and Freddie Mac and has taken full responsibility for all their debts; Treasury is buying mortgage debt; the Fed is discounting mortgage paper and lending to many financial institutions involved in the mortgage market. These are all add-ons to the standards federal involvement through FHA, the Veterans' Administration, and tax subsidies to mortgages.

Possible reasons for high mortgage rates:

- Funding competition from bank deposits. The government has expanded guarantees for banks without focusing investors on the improved safety of agency debt since the government takeover.

- Fannie Mae's borrowing cost on GSE debt is 100 basis points higher than Treasury's (the agency or debt spread). Treasury should be able to substantially reduce the spread between Treasuries and GSE agency debt (by perfecting the federal guarantee, buying agencies to emphasize their safety, encouraging traditional buyers to step back into the market).

Agency Spread: Fannie Mae Bond Yield minus Treasury (last obs. Oct 20, 2008)

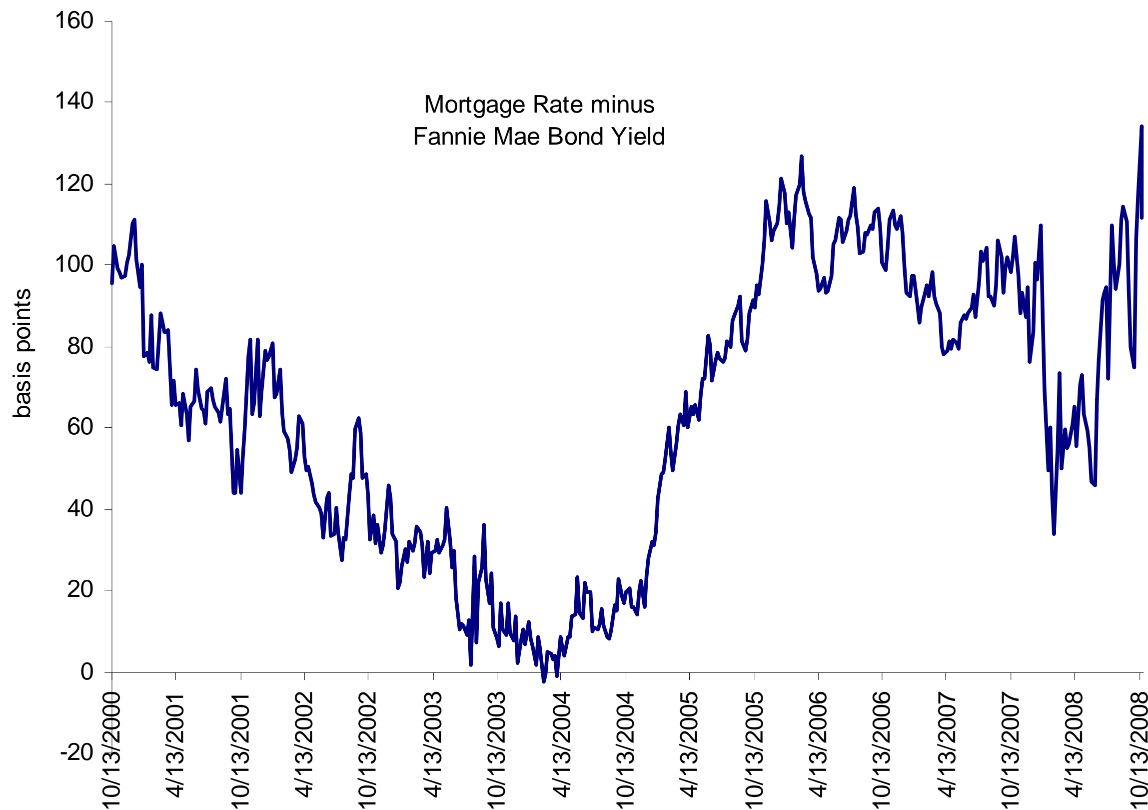


Source: Haver; Encima Global

- There is still a wide spread (like a profit margin) between mortgage rates and the GSE cost of funding. The GSEs don't need a large profit margin now given the credit crisis and government control.

- The GSEs could force mortgage rates down by buying more conforming mortgages and either holding them or securitizing them. This is not an instant process, but it should be doable in coming months.

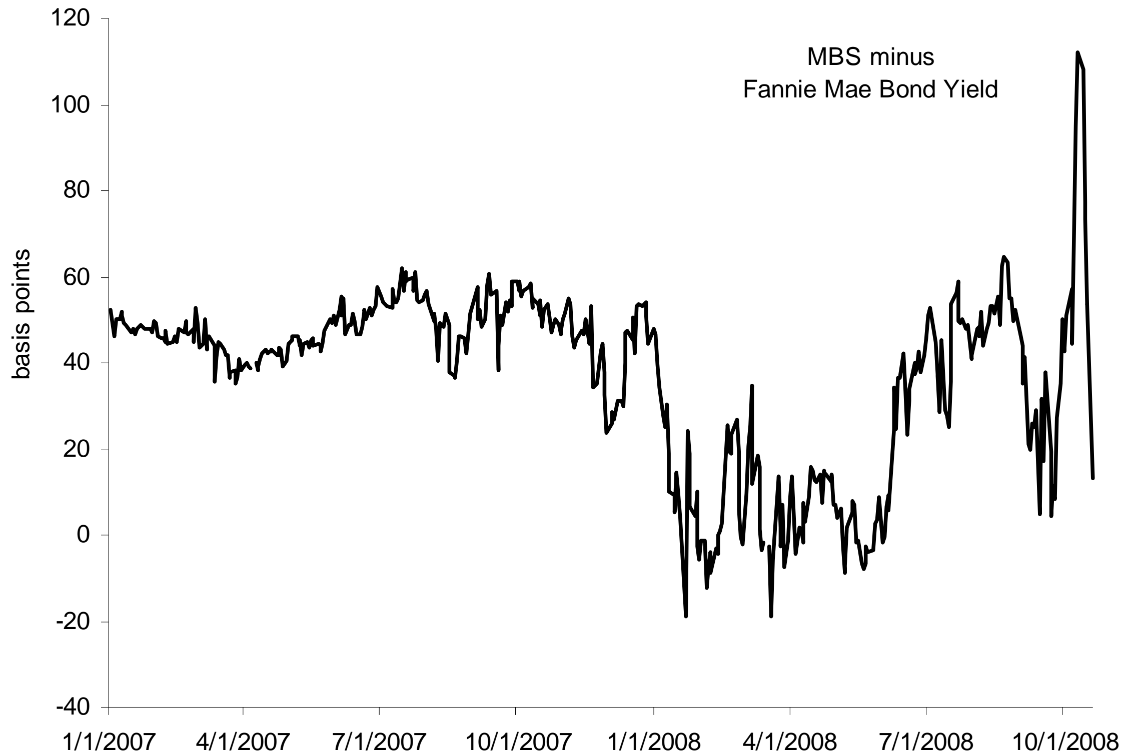
Mortgage Rates minus Fannie Mae Bond Yield (last obs. October 20, 2008)



Source: Haver; Encima Global

* The yield on agency-guaranteed mortgage-backed securities was particularly volatile during the recent financial crisis. The spread to agency debt rose briefly to 112 basis points on October 10. Some reasons for volatility: new competition from bank deposits; risk aversion by traditional buyers of agency MBS; confusion regarding the legal status of agency MBS; prepayment risk in the event mortgage rates fell substantially.

MBS minus Fannie Mae Bond Yield (last obs. October 20, 2008)



Source: Haver; Encima Global

* We think mortgage rates could be quickly lowered with existing government programs.

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