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Economics Group

Interest Rate Weekly

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Mortgage Rate Spreads: A Permanent Structural Shift?

With the Fed's decision to hold mortgage-backed securities on their balance sheet to maturity as opposed to selling some of these securities, there are implications for mortgage rates and spreads going forward.

"Minimizing the effect of Federal Reserve holdings on the allocation of credit across sectors of the economy"

Those words were part of the FOMC's Policy Normalization Principals and Plans published following the September FOMC meeting. However, the statement goes on to indicate that that the Committee does not anticipate selling agency mortgaged-backed securities as part of their policy normalization plan. As Richmond Fed President Jeffery Lacker points out, the act of not selling MBS holdings may put downward pressure on mortgage rates relative to other interest rates which, in turn, would be affecting the allocation of credit across sectors of the economy. In other words, the plan as outlined by the Committee tilts the playing field in favor of home mortgage borrowers and against other borrowing by consumers.

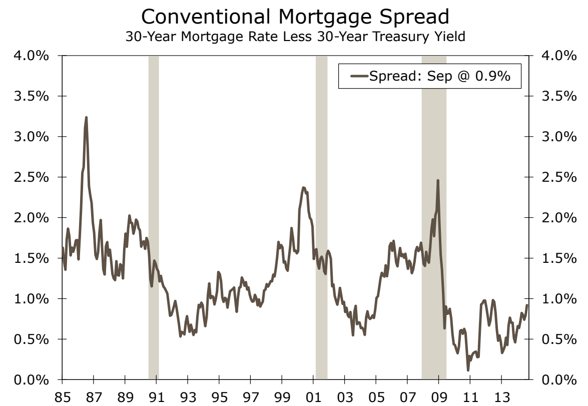
Things are Already Different

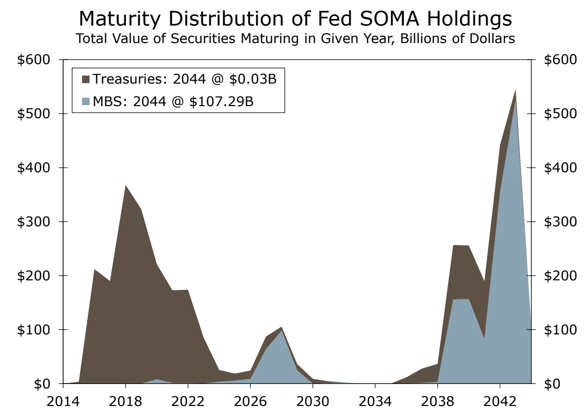
Given the size of the FOMC's purchases of MBS, we have already found a structural shift in historical spreads between conventional mortgage rates and the 30-year Treasury rate. The table to the right shows the average spread between the conventional mortgage rate and the 30-year Treasury. From the mid-1980s through 2009, the spread averaged 135 basis points. From 2009, when the bulk of the first QE program went into effect, through September of this year, the spread averaged just 69 basis points. In addition to the tightening of the spread, the correlation between the two yields is also breaking down. The correlation between the two yields was 0.98 before the QE program's effects but has since declined to 0.86. The breakdown in both the spread relationship and the correlation between the two yields suggests a structural shift.

What Can We Expect Going Forward Given the Fed's Guidance?

Given the structural shift in the relationship between these two rates, the next question is what will happen when the QE program ends and the FOMC begins to implement their policy normalization plan. Given that the Committee has decided not to sell their MBS holdings but rather hold them to maturity, it is likely that the breakdown in the spread between the conventional mortgage rate and the 30-year Treasury will continue. While we expect interest rates to rise after the first of the year in anticipation of the first Fed Funds rate hike in June of next year, the intentional discrimination across credit sectors of the economy should translate into a much tighter spread relationship between these two interest rates going forward. Consumers should expect mortgage rates to rise, however the pace of the rise, as well as the level of mortgage rates, is not likely to "normalize" anytime soon, especially considering that most of the mortgage-backed securities on the Fed's balance sheet do not mature until well after 2038, although prepayments may affect this timeline.

30-Year Treasury vs. Conventional Mortgage Rate	
Correlation ('85 - '09)	0.98
Correlation ('09 - Present)	0.86
Average Spread ('85 - '09)	1.35
Average Spread ('09 - Present)	0.69





Source: Federal Reserve Board, Federal Reserve Bank of New York and Wells Fargo Securities, LLC

Wells Fargo U.S. Interest Rate Forecast

	Actual				Forecast							
	2014				2015				2016			
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q
Quarter End Interest Rates												
Federal Funds Target Rate	0.25	0.25	0.25	0.25	0.25	0.50	0.75	1.00	1.25	1.75	2.25	2.75
3 Month LIBOR	0.23	0.23	0.24	0.23	0.38	0.75	1.00	1.25	1.50	2.00	2.50	3.00
Prime Rate	3.25	3.25	3.25	3.25	3.25	3.50	3.75	4.00	4.25	4.75	5.25	5.75
Conventional Mortgage Rate	4.34	4.16	4.16	4.06	4.11	4.24	4.26	4.42	4.64	4.87	5.12	5.38
3 Month Bill	0.05	0.04	0.02	0.03	0.18	0.55	0.80	1.05	1.30	1.80	2.30	2.80
6 Month Bill	0.07	0.07	0.03	0.05	0.23	0.60	0.85	1.10	1.35	1.85	2.35	2.85
1 Year Bill	0.13	0.11	0.13	0.10	0.28	0.65	0.90	1.15	1.40	1.90	2.40	2.90
2 Year Note	0.44	0.47	0.58	0.35	0.87	1.32	1.38	1.99	2.08	2.31	2.81	3.21
5 Year Note	1.73	1.62	1.78	1.39	2.06	2.41	2.47	2.65	2.88	3.02	3.29	3.56
10 Year Note	2.73	2.53	2.52	2.17	2.51	2.64	2.66	2.82	3.04	3.27	3.52	3.78
30 Year Bond	3.56	3.34	3.21	2.94	3.30	3.43	3.46	3.61	3.78	3.92	4.21	4.48

Forecast as of: October 17, 2014

Wells Fargo U.S. Economic Forecast and FOMC Central Tendency Projections

	2014	2015	2016
Change in Real Gross Domestic Product			
Wells Fargo	2.0	2.7	3.1
FOMC	2.0 to 2.2	2.6 to 3.0	2.6 to 2.9
Unemployment Rate			
Wells Fargo	5.9	5.5	5.3
FOMC	5.9 to 6.0	5.4 to 5.6	5.1 to 5.4
PCE Inflation			
Wells Fargo	1.6	2.0	2.1
FOMC	1.5 to 1.7	1.6 to 1.9	1.8 to 2.0

Forecast as of: October 17, 2014

NOTE: Projections of change in real gross domestic product (GDP) and in inflation are from the fourth quarter of the previous year to the fourth quarter of the year indicated. PCE inflation is the percentage rate of change in the price index for personal consumption expenditures (PCE). Projections for the unemployment rate are for the average civilian unemployment rate in the fourth quarter of the year indicated.

Fed Data as of: September 17, 2014

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