

Doug Fabian's

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It now is time for some real estate-related insights from one of the brightest experts in the business, my personal real estate and mortgage advisor Josh Lewis. Josh will tell us this week why it is so critical to act now, especially if you have one of those risky, adjustable rate mortgages.

Take it away Josh.

## **Why Mortgage Rates Aren't Going Significantly Lower**

By Josh Lewis, Certified Mortgage Planner

In any given week, I speak with five-to-15 people needing mortgage financing. Recently, the most common question I hear from these folks is some version of the following: "I read that the Fed is going to have to continue cutting rates. Shouldn't I wait for mortgage rates to go down before doing anything?"

This is an important question for anyone in need of a new loan. The fact that we are entering a period with more adjustable rate mortgage resets than any other time in history makes this a critical question for many people to answer.

Let's start by discussing what effect Fed rate cuts have on mortgage rates. In reality, there is no direct impact on mortgages. In a textbook case of "buy the rumor, sell the fact," most Fed cuts actually lead to higher rates in the near term. The reason for this is that the markets always are trying to assimilate the information available to predict what will happen going forward. Fed moves are no different. If the interest rate markets feel a Fed cut is coming, they will bid prices up and drive rates down. The markets do this before any actual Fed actions.

When the actual cut arrives, the markets then begin to anticipate the next move. If the markets expect a long series of cuts, they may push rates even lower. But if they are uncertain, or concerns arise that the cut may be the last in a series, they turn their eyes to inflation. Rate cuts are inflationary in that they are an indicator of a loose credit policy. If it's easy to buy things with low-rated credit, demand goes up and prices rise. This inflation is the enemy of all types of bonds because it reduces the future value of bond payments.

Consider it this way. If you buy \$10,000 of Treasury bonds at 4.5%, your nominal return will be 4.5%. But what you actually are most concerned with is the real return, or how much you earn in interest after removing the rate of inflation. In recent years, inflation has run between 2% and 3%, so you would have earned 1.5% to 2% on your \$10,000 investment. If inflation creeps up to 3.5%, your real return now is only 1%. Since investors want greater returns than 1%, even on incredibly low-risk investments like U.S. government debt, prices on these bonds will fall and the yield (rate) will increase.

In short, Fed cuts indirectly impact the interest rate markets. Since Fed cuts are inflationary over the long run, they usually lead to higher rates, especially as we get closer to the end of a Fed-easing cycle. What does that tell us about the current market?

Well, this week the Fed released the minutes of its last Federal Open Market Committee (FOMC) meeting, where a decision was made to cut rates by  $\frac{1}{4}\%$ . Their notes showed that this was far from a unanimous decision, with several voting members believing it would be more prudent to hold off and see if the economy can stabilize without their assistance. They are forecasting a soft landing with strong employment and stable inflation. This is an indication that we are nearing the end of the current easing cycle.

That is what the Fed is saying they expect to happen. Currently, the interest rate markets are telling a different story. The federal funds rate, which the Fed directly controls, currently is at 4.5%. The 10-year Treasury, which is a proxy for market expectations of future Fed moves, currently is at 4.05%. A spread this large (.45%) indicates that the interest rate markets are concerned about the risks of recession and believe strongly that the Fed will be forced to lower more in the future.

In fact, most interest rate market experts, notably Bill Gross of PIMCO, believe that the Fed will continue cutting at least until we see a Fed Funds Rate of 3.75%. Getting to that level would require three more  $\frac{1}{4}$  point Fed cuts. As you can see, based off of the 10-year Treasury, the markets already have priced two of these three cuts into current rates. If the experts are right, and there are three cuts ahead, there is only about .25% more for 10-year Treasury rates to move down.

Now, let's close the loop. We talked about Fed moves and how they impact Treasury bonds, especially the 10-year note. That leaves one question to answer: "How does the rate on the 10-year Treasury note impact mortgage rates?"

The short answer is that mortgage rates follow the 10-year Treasury. If you have ever heard the term "flight to quality" you are aware that this often refers to money coming from risky investments into Treasuries. Since Treasuries represent U.S. government debt, it is considered the safest investment in the world. Since Treasuries are considered so safe, they

offer the lowest yield of any bonds in the world.

You can measure the risk of any other bond by measuring the premium to Treasury debt that they offer. If a bond is considered "junk," it will yield anywhere from 5%-9% more than a comparable Treasury bonds to compensate for the increased chance of default.

During the housing boom when home values were skyrocketing and mortgage defaults were almost unheard of, mortgage bonds came to be perceived as the next best thing to U.S. government debt in the world. If you ran a large endowment or pension fund and you needed to invest in safe securities but get a better yield than Treasuries, you would buy mortgage bonds (pools of individual mortgages of similar quality sold on Wall Street). This demand drove the spreads between Treasuries and mortgage bonds to historical lows.

We currently are in the midst of a housing downturn with mortgage defaults skyrocketing. As a result, the perception of mortgage bonds has changed considerably. Investors no longer see mortgages as the next best thing to U.S. debt, and as a result demand has decreased immensely. With decreased demand, prices have dropped and yields have increased.

Depending on the type of loan you need, the increase in relative rates could be minimal or massive. If you are looking for a full doc, conforming (under \$417,000) loan, the premium to 10-year Treasury rates is just slightly above where it has been historically. If you are looking for a \$750,000 stated-income loan, you will be looking at a stiff premium above the vanilla loan in the previous example (and you better have real good credit and a nice-sized down payment or equity position).

The bottom line is that there is very little demand for mortgage bonds due to the current downturn in housing. As a result, rates are trending down along with Treasuries, but at a much slower rate. Since it appears that Treasuries are within .25%-.35% of their bottom for the current trend, mortgage rates are likely within .25% or less of their cycle lows.

If you are in a risky loan and you need to refinance, that is not enough incentive to wait. With home values dropping and lender guidelines tightening by the day, holding out for less than ¼% improvement could mean the difference between being approved or declined for your loan.

I know this is a ton of information to throw at you, but I believe this information is **CRITICAL** for so many people right now that I wanted to get it out to you.

If you have questions, need clarification or want to talk about your options, call me today at 888.944.5674 ext. 1, or [click here to send me a message](#).



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