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MAY 6, 2020

Global Fixed Income

Mortgage rates remain stubbornly high


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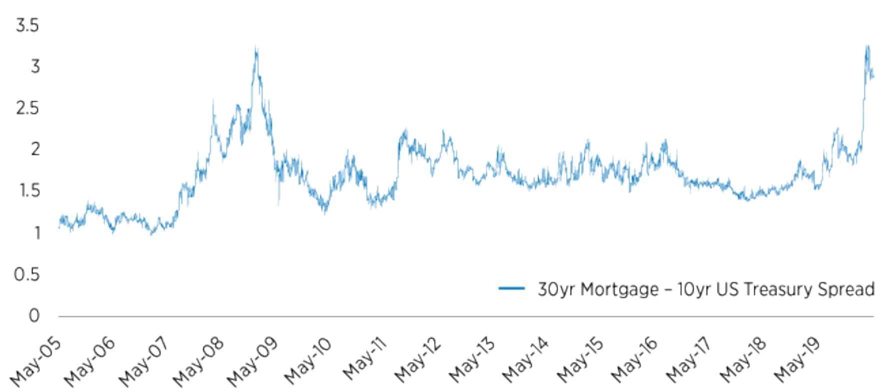
Boston - The rate on a 30-year fixed mortgage is 3.52% in early May[1] — attractive by historical standards but still a long way from the record low. In normal times, this wouldn't be newsworthy. However, now that the Federal Reserve has purchased almost $600 billion in agency mortgage-backed securities (MBS) since restarting quantitative easing (QE) in March, the results are pretty underwhelming.

In fact, when we compare prevailing mortgage rates to the 10-year US Treasury yield, we find they aren't cheap at all, but rather at the widest spread — or highest relative rate — since 2008.

US mortgage rate spread over Treasurys now as wide as in 2008



Source: Bloomberg daily data from May 6, 2005 to May 1, 2020

"Unintended consequences of government policies meant to reduce consumer borrowing costs have instead achieved the opposite by squeezing mortgage originators."

There are some fairly intuitive reasons for what's holding back mortgage origination. Social distancing impacts everything from attendance at open houses to appraisals to in-person closings with attorneys. Staff at the largest originators responsible for processing the deluge of paperwork are also working from home at presumably less than 100% capacity.

But there are also some counterintuitive technical impediments keeping rates sticky around 3.5%. These unintended consequences of government policies meant to reduce consumer borrowing costs have instead achieved the opposite by squeezing mortgage originators both pre- and post-closing.

Diverting capital from mortgage lending to meeting margin calls

Whenever a borrower "locks" a mortgage rate with a lender, the lender sells the loan into the agency MBS market for settlement in two months. This helps to mitigate interest rate risk for the lender, who is now long a mortgage loan and short agency MBS.

In March, this business model came under pressure as the short MBS hedge skyrocketed in value when the Fed began purchasing hundreds of billions of agency MBS. Originators were then forced to divert capital from lending to meeting margin calls on their agency MBS short positions — the exact opposite result of the Fed's intentions.

Mortgage servicing under pressure from delinquencies

The other pain point relates to mortgage "servicing" where borrower payments are processed and remitted to bondholders for a small fee. When delinquencies are low, this tends to be a very profitable business — and a key driver of loan origination economics — as it costs next to nothing to process an automatic payment.

But again, this dynamic changed in March when Ginnie Mae, Fannie Mae and Freddie Mac, the government agencies that guarantee agency MBS, announced that all homeowners would be granted 6 to 12 months of forbearance, essentially pausing mortgage payments. This policy change put servicers in a bind because they would still be required to advance principal and interest to government-guaranteed agency MBS bondholders, even though no cash would be coming in the door from many borrowers.

Agency MBS bondholders are guaranteed timely payment by the US government, regardless of forbearance status. Even in the case of a default at the end of the 12-month forbearance extension, agency MBS bondholders are guaranteed to be paid back at par. With almost 7% of homeowners seeking forbearance through mid-April, these mortgage servicing rights (MSR) quickly turned from an asset into a liability, causing a further pullback in lending.

Bottom line: At the end of the day, a 3.5% 30-year fixed mortgage rate is still low by historical standards. But in our view, many physical and financial considerations could keep that rate 100 basis points higher than where it should be, given how low Treasury rates are.

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[1] Source: Bankrate.com US Home Mortgage 30-Year Fixed National Average as of May 4, 2020.

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