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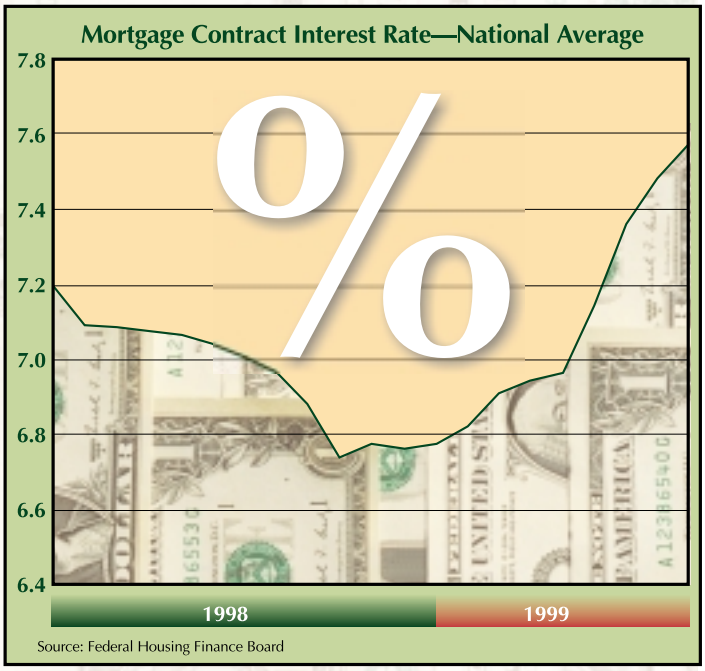
Rising rates

Increasing mortgage cost may cool housing demand

Compiled by the Research Staff

Inflation is one of the things that affects interest rates. At the inflation rates that have prevailed in recent years, mortgage rates should be in the 6–7 percent range. Of course, the inflation rate that is built into interest rates is the rate expected to occur over the term of the loan. When the nominal rate turns like it did in 1999, it could indicate that financial markets expect a bit more inflation in the next several years.

After sliding through much of 1998, mortgage interest rates bottomed out in the fall and headed upward during 1999. And, while rates are still quite low by historic standards, they are hitting levels not seen since 1995. Any sustained upward turn raises the specter of a return to rates that would put an end to the housing market rally. Examining what has been making rates rise gives some perspective on what to expect in the near future.



Rates have fallen this far because of the confidence the capital markets have in Federal Reserve (Fed) policies. However, Fed Chairman Alan Greenspan's frequent warnings of over-exuberant markets may have sensitized investors to see inflation threats at every turn. While they are reassured by the Fed's willingness to tighten, they worry about a series of interest rate hikes.

The Fed can affect mortgage markets with such a prolonged series of rate increases. The most recent evidence is 1994, when successive rate hikes provided an interruption in the generally upward trend of home sales (the chart shows how dramatic the market response was to that rate increase).

Increased demand for loans is another factor that can raise interest rates. With home sales booming, there is great pressure on the supply of funds available for lending. Not to be discounted is the wide-spread use of home equity loans and cash-out refinancings (total refinancings have been making up about half of all mortgage loans nationally, according to the Mortgage Bankers Association; even with the higher interest rates in mid-1999, the rate fell only to 38 percent).

The effect of increased demand on interest rates was demonstrated during the past year. From about 125 basis points (1.25 percent) two years ago, the spread of mortgage rates over ten-year treasury bond constant maturity yields rose to 180 basis points by mid-1999. Some point to big new issues of Fannie Mae and Freddie Mac securities as a major reason for the spreading yield gap. These issues indicate the extraordinary demand for mortgage debt and suggest that rates may have risen even had the Fed not tightened.

By and large, interest rate forecasts are not worth much and actually could be dangerous if someone were to take them seriously. However, it can be instructive to look at what might happen to the fundamentals that determine mortgage interest rates.

Fed policy. Will the Fed tighten further? When the discount rate is raised, all interest rates tend to follow. As seen in the rate pattern of 1994, mortgage rates certainly respond to these hikes. But the mortgage market also wants to see a Fed policy of low inflation. So tightening can be important in keeping inflation expectations low. The Fed seems to be leaning toward more increases. Here are some things that might affect whether this bias becomes action:

- Evidence of too rapid growth. If employment growth gets too high, the Fed will have to do something to retain its credibility. There also seems to be concern about the strength of the housing market. Continuation of booming sales may induce rate hikes.
- Budget surplus. If surpluses materialize as projected (the Congressional Budget Office predicts a $161 billion surplus for this fiscal year), the Fed would feel more leeway to raise rates.
- Good news on loan defaults and bankruptcies. It would be difficult to raise rates if signs of financial distress are evident.
- Rising prices. Jumps in the Consumer Price Index would demand response.

Although the Fed increased rates in 1999, market rates also were boosted by a perception of greater risk, largely because of foreign financial crises. As these fears die down, rates should ease a bit.

Demand. The demand for mortgage credit has been soaring in recent years. Although refinancing might be considered recycled money, the new loans often exceed the old ones, and thereby represent new demand (refinancing also acts to lengthen the maturity of the debt in most cases).

The growth in housing markets and home equity lending in recent years has boosted demand for mortgage credit. Also, mortgage lenders have been aggressive in taking on more risky loans. All mortgage entities with ties to the federal government have been urged to make special loans available to those who might not otherwise qualify. Forty-two percent of Fannie Mae's 1998 loan purchases were in "affordable housing" programs featuring low down payment requirements and liberalized qualifying criteria. The Federal Trade Commission reported that 10 percent of mortgage loan holdings are of the "sub-prime" variety (loans to borrowers with flawed credit histories). These trends not only expand the demand for credit, they increase risk premiums as well.

Expect demand to continue to climb as long as the economy prospers. If it falters, there may not be a lot of relief because of the risk taken on by mortgage lenders. Should delinquencies become a problem, risk premiums will rise to counter any reduction brought about by lower demand. Furthermore, any reduction in interest rates based on poorer economic conditions will have little simulative effect on real estate markets.

Possibly the best scenario for this year is a moderate increase in rates. Some increase could cool the rise in home prices without doing much to slow down sales.

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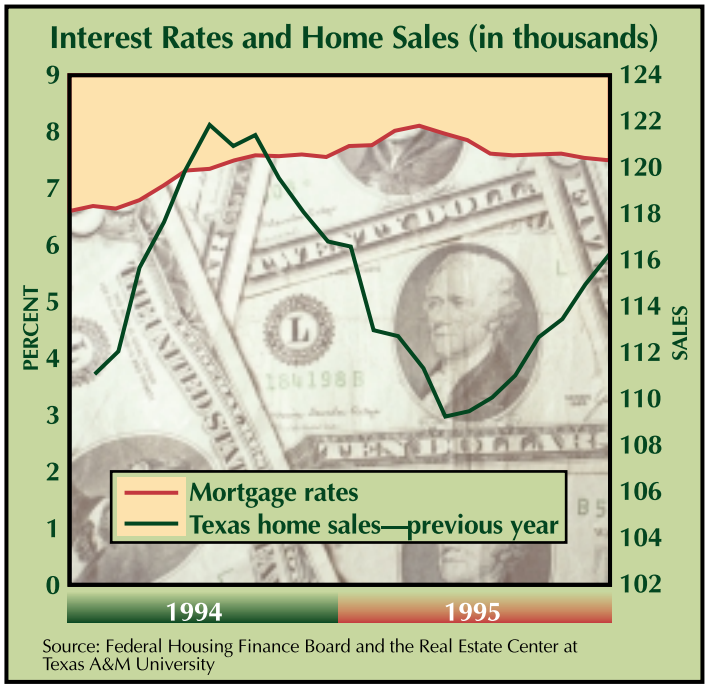

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