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By Mark G. Dotzour

Heart of the Housing Market

Residential mortgages are a vital part of the housing market. While there have been large numbers of cash sales in recent years, most homebuyers in America do not have enough funds to pay cash for a home. In fact, many face a difficult time coming up with a modest down payment.

When mortgage rates are low, homeowners can buy larger, more expensive homes. Higher rates preclude them from buying larger homes because the monthly payments increase beyond their ability to pay. Consequently, changes in mortgage rates have a profound impact on sales of single-family houses.

What causes mortgage interest rates to change? Understanding the factors influencing these rates enables real estate professionals and potential buyers to better understand mortgage rate trends. A potential homebuyer may defer purchasing if they think mortgage rates are likely to fall from current levels. Conversely, if they think rates could rise in the near future, they may buy before rates increase.

The 30-year, fixed-rate mortgage rate moves closely in tandem with the ten-year U.S. Treasury bond rate. Bond investors have numerous choices for investments, including residential mortgages, Fannie Mae and Freddie Mac bonds, corporate bonds and U.S. Treasury bonds. When the interest rate on the ten-year Treasury bond goes up 1 percent, it's highly likely that the interest rate on all the other bonds will increase by nearly the same amount.

Figure 1 shows the relationship between the 30-year conventional mortgage rate as reported by Freddie Mac and the rate on the ten-year Treasury bond reported by the Board of Governors of the Federal Reserve for the past 14 years. When the ten-year Treasury rate moves up, mortgage rates almost immediately move up as well. Conversely, if the ten-year drops, mortgage rates fall. Busy real estate professionals can stay abreast of changes and current trends in mortgage rates by following the

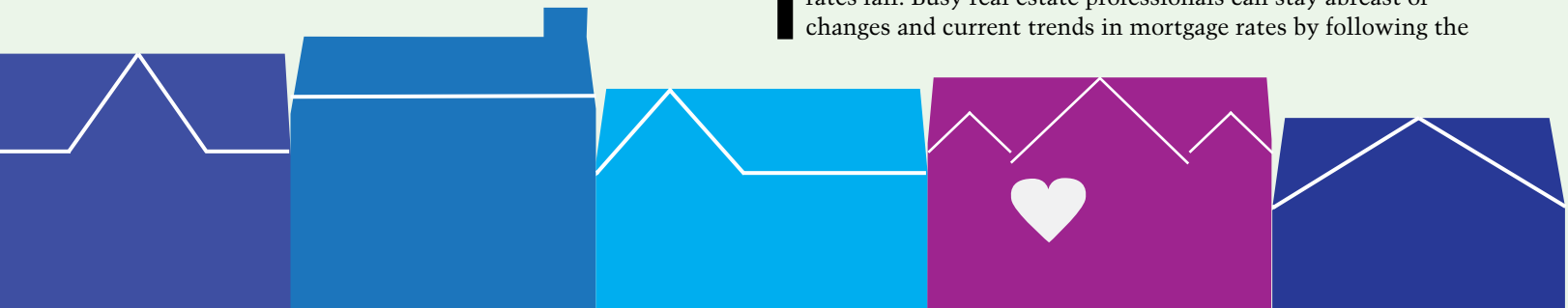
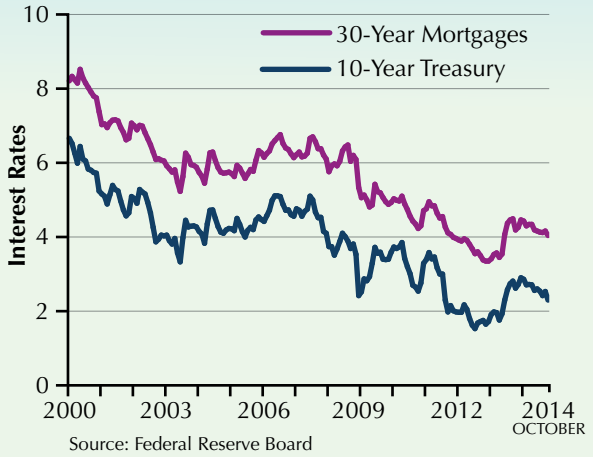


Figure 1. Mortgage Rates and Treasuries



Source: Federal Reserve Board

ten-year Treasury rate through the Federal Reserve Bank of St. Louis (http://research.stlouisfed.org/fred2/series/GS10).

Notice that the mortgage rate is always higher than the Treasury rate. That's because investors perceive mortgages to be a riskier investment than U.S government debt. Over the 14-year period, the average mortgage rate was 5.62 percent, and the average Treasury rate was 3.84 percent. The difference between the two rates is known as the risk premium on mortgages or "the spread." Over the period, the spread averaged 1.78 percent. So the 30-year mortgage rate is likely to be about 1.8 percent higher than the current ten-year Treasury rate.

While it's clear the two interest rates move closely in tandem, they are not perfectly correlated. In other words, the spread can vary. Sometimes the risk premium is higher than average. Since 2000, the mortgage rate has usually been between 1.5 and 2.0 percent higher than the current Treasury rate (Figure 2). Notice the big spike in 2008, when the spread

Figure 2. The Spread (Risk Premium) for Mortgage Loans, 30-Year Mortgage Rate, 10-Year Treasury Rate

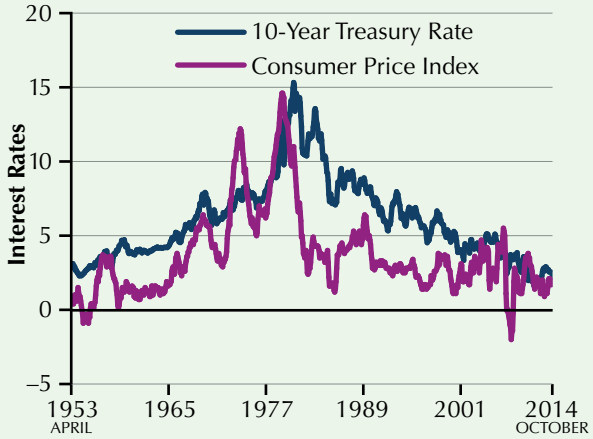
Source: Federal Reserve Board

exploded to almost 3 percent. That's what happens when bond investors lose faith in the American housing market.

What causes the ten-year Treasury rate to go down or up? The answer is the expected rate of inflation. How much inflation do investors expect to see over the next ten years? If investors anticipate high inflation in the future, interest rates on Treasury bonds will be high. Inflation was high in the late 1970s and early 1980s. So were interest rates.

Figure 3 shows how the ten-year Treasury rate and the Consumer Price Index (CPI) have moved together since 1953. Inflation peaked at an annual rate of 14.6 percent in March 1980. The ten-year Treasury rate peaked at 15.32 percent in September 1981. Aggressive Fed policies were successful in taming the runaway inflation of the late 1970s. Since then, inflation has

Figure 3. Ten-Year Treasury Rate and Consumer Inflation



Source: Federal Reserve Board

fallen and the ten-year rate has dropped with it. Inflation has been above 5 percent for only three months since 2000, and above 4 percent in only 13 months. Conversely, the CPI inflation rate has been less than 2 percent for 59 months.

Mortgage rates are largely determined by the interest rate on the ten-year U.S. Treasury bond. The rates are, on average, about 1.8 percent higher than the prevailing Treasury rate. The Treasury rate is influenced largely by the expected rate of inflation. The United States had low rates of inflation for the first 14 years of the 2000s. Real estate professionals who want to follow mortgage rate trends should keep an eye on the ten-year bond rate and the outlook for future inflation.

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THE TAKEAWAY

Residential mortgage rates have a strong relationship with the current interest rate on the ten-year U.S. Treasury bond. The mortgage rates are likely to be somewhere between 1.5 percent and 2 percent more than the current Treasury rate.

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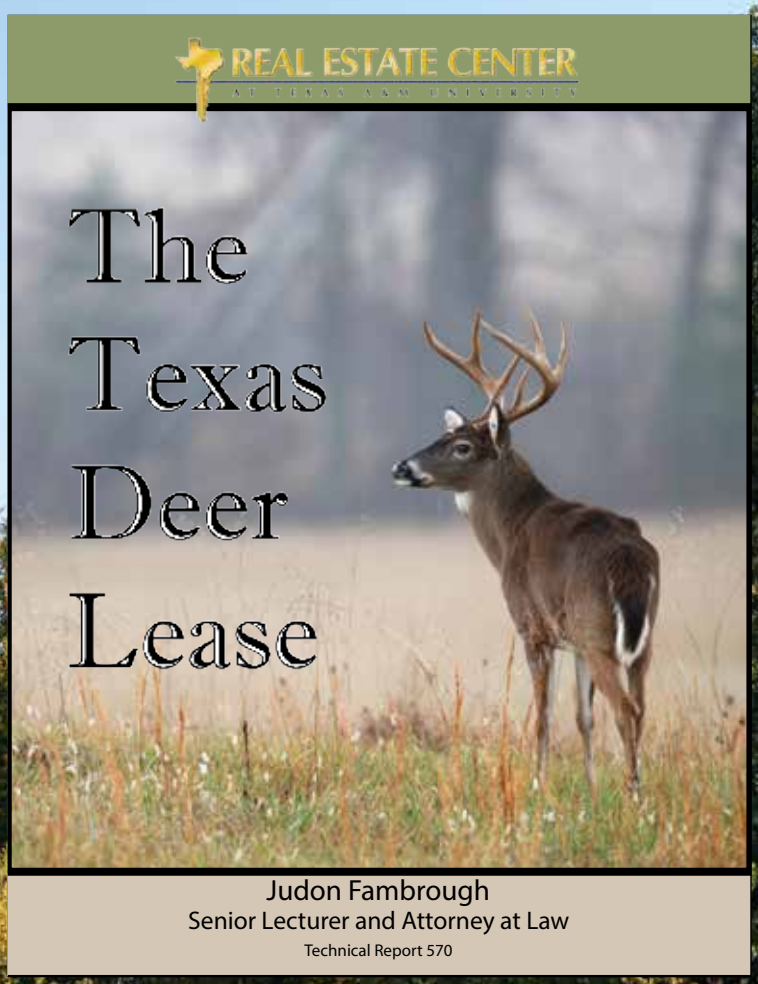

It's All About the Big Bucks

Another deer season has come and gone. Lucky hunters have a buck in the freezer. For landowners, the bucks are in the bank. But not everyone is happy. More often than not, their problems have something to do with the deer lease. Make sure your lease doesn't have holes in it.

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