



Fed Rate Cuts Do Not Equal Lower Mortgage Rates

By Barry Habib
Contributing Editor to CNBC.com

So the Federal Reserve may cut rates again. Many mortgage applicants are calling their mortgage representative and expecting a lower interest rate. Others who have been waiting to refinance are puzzled as to why mortgage rates have not moved lower when the Fed cuts rates. In fact mortgage rates typically move in the *opposite* direction from the Fed move. This is difficult to explain to consumers who have watched a rate reduction by the Fed with no benefit in mortgage rates.

Is a Fed rate cut really good news for mortgage rates? The facts may be surprising. The Fed can only control the Discount Rate and the Fed Funds Rate. This is very different from mortgage rates. A mortgage rate can be in effect for 30-years, a rate that is set by the Fed can change from one day to another.

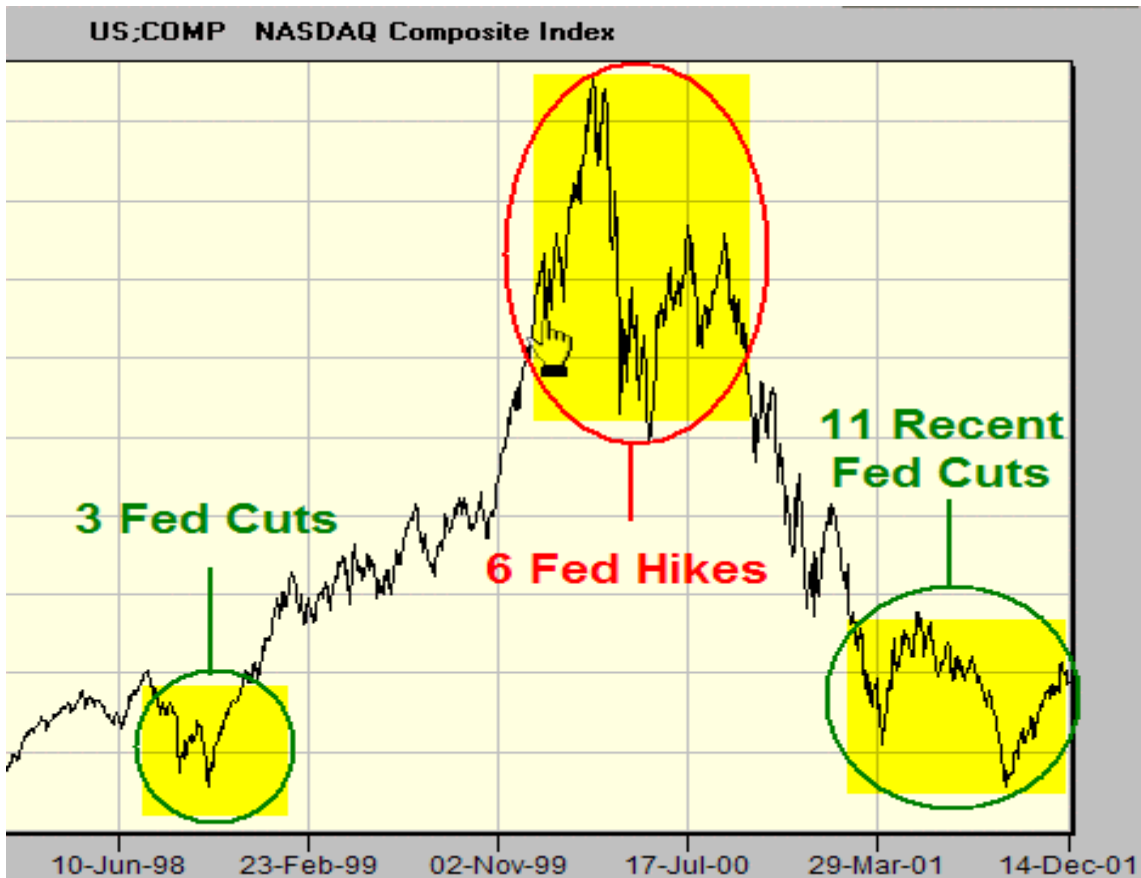
A look at some recent history shows that when the Fed cuts rates mortgage rates go *up...not down*. In the late part of 1998, with mortgage rates around 6.5%, the Fed cut rates 3 times. Mortgage rates shot up by over 2% during the next year. Then, in the spring of 2000 and after 6 Fed rate hikes, mortgage rates declined from 9% to 6.75% over the next 9 months. In 2001 the Fed cut rates 11 times. But mortgage rates were actually higher after the 11 Fed cuts.

Why do mortgage rates seem to defy logic and move contrary to the Fed direction? Most often it is because Stocks and Bonds compete for the same investment dollar. So if stocks like the Fed decision to cut rates and rally, bonds typically worsen. If stocks react poorly to a Fed rate hike, bonds are usually the beneficiaries.

As bond prices rise, interest rates fall. As bond prices fall, interest rates rise. The charts accompanying this article show the Nasdaq Composite Index and the Fannie Mae 6.5% mortgage bond tend to follow paths that are almost mirror images of each other. The consistency of this behavior is astounding.

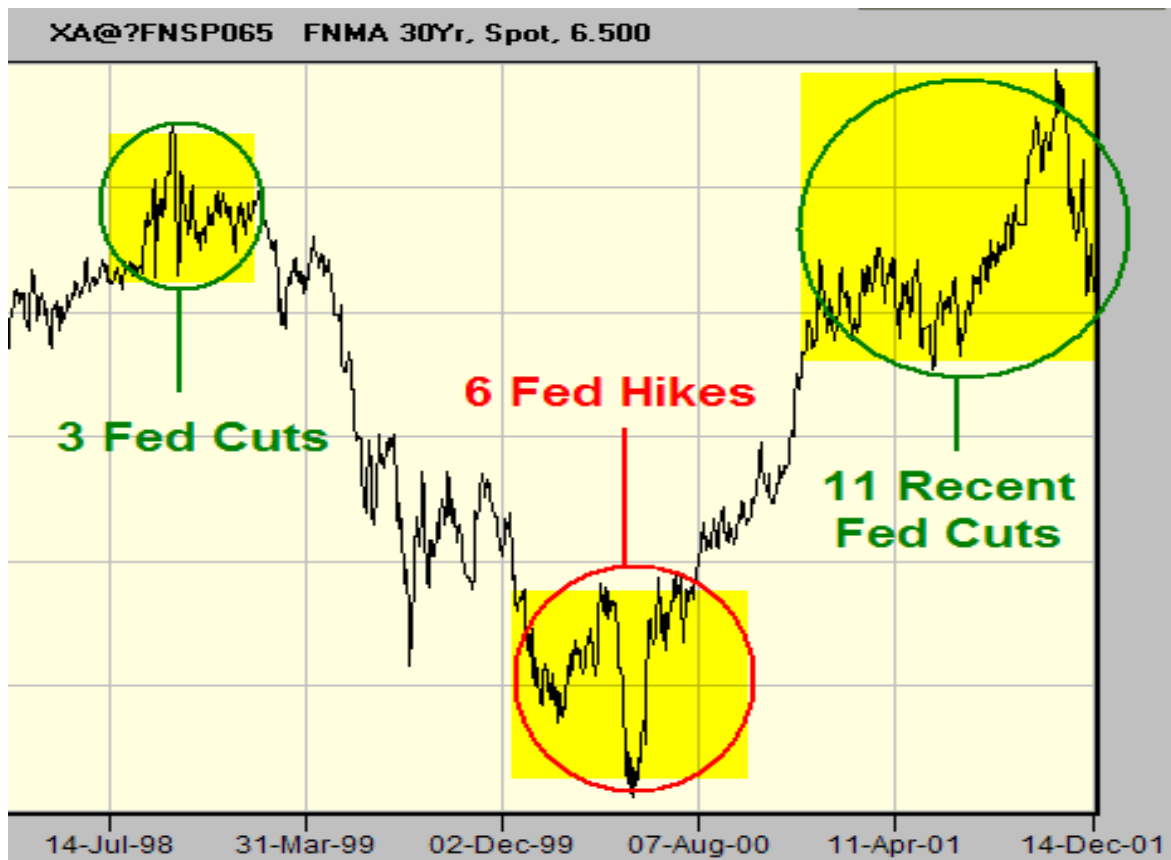
As the Nasdaq moves higher, bond prices move lower causing interest rates to rise. As the Nasdaq declines, mortgage bonds benefit, causing mortgage rates to fall. Additionally, and unlike common opinion, Fed rate cuts have had virtually no direct effect on mortgage rates. Moreover, it appears that since Fed rate cuts act to stimulate the Nasdaq, they have a negative effect on mortgage rates.

The bottom line is that it appears mortgage rates will get better if the stocks sell off and will get worse if the stocks rally. So it is not necessarily what the Fed does that affects mortgage rates, it's how the Nasdaq and broader stock market interprets the Fed's action that will ultimately influence the direction of mortgage rates. This is because money managers and mutual fund companies typically keep funds in either stocks or bonds with very little in cash. If stocks are in favor, money is pulled from bonds, causing bond prices to drop and interest rates to rise. When stocks are being sold off, the money is then parked into bonds, which improves bond prices and causes interest rates to decline.



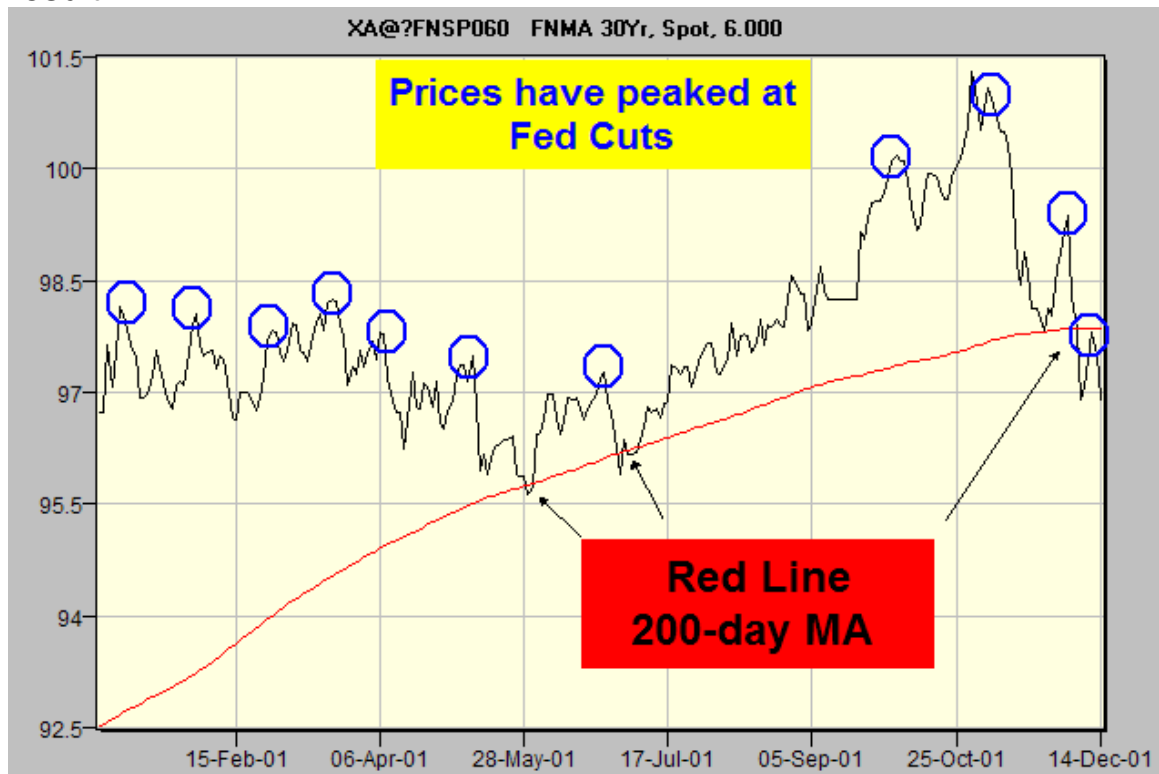
On the chart of the Nasdaq Composite Index above, notice how the price movement higher on the Nasdaq seems to correlate to mortgage bond price deterioration (shown below) and vice versa. Once again, lower bond prices translate to higher mortgage rates and higher mortgage bond prices mean lower mortgage rates.

The chart below shows how the Fannie Mae 6.5% mortgage bond has performed during the same time period. The green circles indicate Fed rate cuts and the area circled in red shows when the Fed hiked rates.



A closer look at the 11 rate cuts by the Fed last year (see chart below) shows that mortgage bond prices deteriorated after each Fed rate cut. This means that mortgage rates rose after the Fed had cut rates while many consumers were expecting their mortgage rates to decline. Worse yet are the consumers who missed the opportunity to obtain a lower rate because they mistakenly waited for the anticipated Fed action to cut short-term rates, thinking that longer-term mortgage rates would decline as a

result.



Predicting the future is tough, so nothing is written in stone. Keep an eye on the stock market, and keep in mind that the best rates may be behind us. But, mortgage rates are still low and could have some quick dips so make the most of them while they last.