BELLA CASA
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Buyer Advisory 2013

Part 1: Your Mortgage Interest Rate

Those who fail to adapt to changing market conditions always get burned. Buyers got burned in the market escalation before 2007 (a 'seller's market'). Sellers often got burned for not adjusting quickly enough during the five year housing crash since 2007 (a buyer's market'). The market is changing again and buyers are at risk.

Mortgage interest rates are the most powerful influence affecting affordability for a buyer. They are also an accurate barometer about changing economic conditions. That interest rates have dropped to a recent mind-blowing 3-3.5% for a 30 year fixed loan is testimony to how bad the housing crash is/was. Since 2012 the housing markets are improving and this means interest rates will go up, especially as the overall economy improves.

How Mortgage Interest Rates Work

- Mortgage interest is long-term debt (e.g. 30 years) and therefore is tied to the bond market, also long-term debt. The Federal Reserve, which we hear about frequently in the news, regulates short term rates such as overnight money or the Prime rate.
- When the economy is bad and worsening, money flees to more stable, fixed, and long term investments. The bond market takes the long view on the economy and produces predictable results regardless of cycles and crises. However, bond yield rates (interest on the investment) drop in difficult times because of increased demand. Five years of bad economic news continued to deflate rates to a low level unprecedented in half a century, but in retrospect that is not a surprise. Good economic news, particularly improving market conditions, causes money to flow from bonds to the stock market, which reacts with quicker reward and also keeps capital more liquid. Recently, the stock market just surpassed the 14,000 level, not seen since before the housing crash. Money is moving from bonds to stocks to cash in. The bond market now has to attract more investors with higher yield rates; interest rates therefore rise.
- Because bonds are a fixed investment for a long period of time, the enemy of bonds is inflation. If I have a 30 year bond (e.g. a mortgage) and inflation causes me to lose 3% per year in real buying power, then that loss comes at the expense of my yield rate (effectively 3% less each year). I am captive to this failing trend unless I can get rid of my bonds, perhaps selling at a loss. Inflation is caused by high government debt and an increasing money supply as the government creates/prints more money to pay its bills. It is worth less than it was because there is more of it. Does this sound familiar? Is inflation a necessary consequence of our spending? If so, then interest rates will also rise.

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Evaluating Our Current Conditions

- Currently, there is little inflation and still too little good economic news. Interest rates have stayed very low. However, inflation is a very real risk. Although the inflation rate officially is low, how many of us already feel the increase in the cost of fuel and food and many other staples of life right now? Prices rise in part to keep up with real value because of inflation and in part because of increased demand and therefore improving market conditions.
- The housing industry is in recovery in most markets nationally right now. Businesses have become lean, efficient, and profitable because of the last 5 years. The stock market is reaching new highs. Unemployment numbers appear to be in decline. Consumer confidence is getting stronger. Will those changes portend a rise in interest rates?
- The federal government has been stimulating the economy and propping it up since the financial meltdown in the fall of 2008. The Federal Reserve continues to buy mortgage bonds at a pace of about $85 billion per month in order to keep mortgage interest rates low. How long can that continue? The Fed also employs various methods to stimulate economic growth. How much longer will that be seen as necessary? Either these props will no longer be needed and so interest rates will rise on the good news, or when these government purchases stop, the artificially low interest rates will be left in the dust.

Predicting the Future and Reading the Tea Leaves

- Predicting the future is something we are addicted to but most often proves futile. However, we can know two things reliably:
  - ✓ We know what we have now, which is a mortgage interest rate for a 30 year fixed loan which is lower than anything known in over 100 years.
  - ✓ We know what will cause these rates to rise. Economic vitality, inflation, and the removal of government props and stimulus will cause interest rates to rise.
- Fluctuation in mortgage rates, which can change several times a day, will likely be with us for a while as our economic news fluctuates widely. Expect rates to rise and fall for a while.

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- How high will rates go? In the early 1980's, because of a serious inflation problem, interest rates commonly exceeded 20% and mortgage interest peaked at over 16%. 10 years ago, before the market run-up, the 30 year fixed mortgage rates were about 8%, double what it is today. 10 years before that (1990) they hovered at 9%.

For 5 years, I have listened to radio commercials from a particular national mortgage broker warning that 'these historic rates cannot last!' Well, they did, and they continued to go down. So much for future prescience!

But like the broken clock (analogue not digital), right at least twice a day, these people will be right at some point. Buyer opportunities today are exceptional but there are good reasons to be concerned that this will change soon. There is logic to what causes rates to rise. If you know the reasons, you can watch, evaluate, and make your own informed decision about when buying a home is good for you and your goals.

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