The Baker Group

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Why Mortgage Rates Remain Stubbornly High Despite Falling Inflation

As most investors know, primary mortgage rates are priced off mortgage-backed securities (MBS). The value of MBS, like all long-term fixed-rate bonds, is influenced by the rate of inflation. This is because the holder of a long-term fixed-rate bond receives payment based upon a fixed coupon rate. Higher inflation erodes the purchasing power of that fixed payment, so bondholders demand a higher yield to compensate for the erosion of purchasing power. This is the reason we often see long-term fixed interest rates, such as mortgage rates, rise when inflation rises and fall when inflation falls.

So why have we not seen any meaningful decline in primary mortgage rates despite falling inflation? Headline PCE, the Fed's preferred measure of inflation, has fallen from its peak at 7% in June 2022 to 3% in July 2023, yet mortgage rates remain stubbornly high. It appears that a few unusual market forces are disrupting this fundamental relationship, at least for the time being.

The strain that banks have felt from the Fed's campaign to rapidly increase short-term interest rates is in part to blame. It helped bring about intense liquidity pressure for many institutions as depositors withdrew funds in search of higher returns from competing institutions and higher earning money market accounts. That caused some institutions to have to liquidate assets, including MBS holdings, to shore up liquidity, which put downward pressure on MBS prices.

That selling pressure was accelerated in the wake of the failures of SVB, Signature Bank, and First Republic Bank. The assets of the failed institutions were acquired by the FDIC and had to be liquidated. The added supply of MBS and other mortgage assets to the market that resulted from these sales also put downward pressure on prices. And because bond prices and bond yields have an inverse relationship, lower MBS prices made for higher MBS yields, which translated to higher mortgage rates as well.

Another impetus working to keep mortgage rates up has to do with the value of servicing rights. A mortgage servicer gets paid to perform the duties of "servicing" a mortgage such as collecting payments, creating tax forms, answering borrowers' questions, etc. They collect payment by retaining a fraction of the interest a borrower pays on their monthly mortgage payment. To have the opportunity to collect that fee, they must purchase the servicing rights up front. The value a servicer places on those servicing rights depends on how long they expect to be able to collect the servicing fee. The longer the expected life of the MBS, the more servicers are willing to pay upfront (the "servicing value") for the right to earn the monthly servicing fee over the long run.

With mortgage rates hovering around 7% and interest rates expected to decline at some point in the future, servicers are not betting that current mortgages will be around for the long-haul. Consequently, they are placing less value on the mortgage servicing rights. Lower servicing values lowers the overall value of new MBS. That pressures MBS prices lower and yields higher, which ultimately helps keep primary mortgage rates elevated as well.

The shorter duration that servicers are expecting of new mortgages is also causing mortgage rates to trade closer to shorter duration Treasuries. Historically, 30-year mortgage rates have traded around 1.75% to 2.0% above the 10-year Treasury yield. That trend has been fairly consistent for the last 35 years until recently. Now it appears that 30-year mortgage rates are trading around 1.75% to 2.0% above shorter duration Treasuries rather than the 10-year. Because the yield curve is currently inverted, those shorter duration Treasuries have higher yields than the 10-year yield, which also keeps mortgage rates elevated.

As some of these forces come back to normal territory, a lot of these dynamics will fall back in line. As the Fed gains a hold on inflation and interest rates fall, mortgage rates should also begin to decline. Servicing values should be able to return, and

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spreads should normalize. With all these dynamics back in place, the fundamental relationship between inflation and long-term rates should also resume. All of this bodes well for investments in long-term bonds such as MBS that have been thrown off course by these one-off occurrences. A return to normal market functioning should support prices and reduce volatility.

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