

Mortgage rates poised to jump as Fed cuts funds

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The Federal Reserve is poised to turn off a major money spigot that has helped sustain the ailing real estate sector, as an extraordinary program under which the Fed has pumped \$1.25 trillion into the mortgage market is slated to end March 31.

"Housing has been on government life support, and without it the crash would have been much more severe," said Mark Zandi, chief economist with Moody's Economy.com in Pennsylvania. "This spring and summer as those policy efforts unwind, we most likely will see mortgage rates move higher and more house-price declines."

Rather than being held by banks, today's mortgages are sliced, diced and resold on Wall Street to create liquidity - money that then can be lent in more mortgages. After the credit crunch beginning in the fall of 2008, investors lost their appetite for these mortgage-backed securities, so the Federal Reserve stepped in to purchase them to ensure that money would keep flowing to home purchasers.

The Fed started buying securities backed by Fannie Mae, Freddie Mac and Ginnie Mae in January 2009 and originally planned to conclude the program by year's end. It extended it for three months to ease the impact on mortgage markets, although it didn't allocate more money. The program's ultimate cost won't be known until the Fed sells off the securities, something that officials said it will do gradually starting this year. It's conceivable that the program could end up generating a modest profit, breaking even or losing money, depending on what prices the securities go for.

While experts agree that the Fed's exit will cause mortgage rates to rise, the big unknown is how severe the effect will be.

"There is no question rates have been kept artificially low by the Fed's heavy buying," said Guy Cecala, publisher of Inside Mortgage Finance. "My opinion is that rates will go up a full percentage point initially," meaning that 30-year fixed conforming loans, now hovering around 5 percent, would hit 6 percent.

Keith Gumbinger, vice president of HSH Associates, which compiles mortgage loan data, thinks that rates will slowly rise to about 5.75 percent after the Fed withdraws.

"Right now the Fed is acting as a sponge, absorbing about \$12 billion a week of what you might consider excess supply," he said. "When they stop, the market will have to pick up some chunk of change."

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Julian Hebron, branch manager at RPM Mortgage's San Francisco office, anticipates a bump up to around 5.5 percent by summer with rate volatility all year.

"The Fed isn't going to start dumping mortgage bonds on April 1, they're just going to stop buying," he said. "By that time, improving economic data is likely to push the Fed toward a rate hike bias. This will contribute to higher mortgage rates, slowing refi activity, and less mortgage bond supply. So while the Fed won't be buying anymore, rates shouldn't spike immediately because there will be less supply for markets to absorb."

Christopher Thornberg, principal at Beacon Economics in Los Angeles, thinks the Fed's withdrawal will have a radical impact.

"Clearly, when they stop printing all that money, it's going to be a shock to the system. I have to assume that when they pull back on it, it will cause a 100- to 200-basis-points rise" to rates of 6 percent or 7 percent, he said. "When they start selling off the stuff they purchased, which by my guess would come early next year, that would cause another 100- to 150-basis-points rise."

The Fed has indicated that it might resume buying mortgage-backed securities if mortgage rates spike.

In written Congressional testimony released last week, Fed Chairman Ben Bernanke said the Fed eventually will take steps to forestall inflation that also are likely to result in higher interest rates for all loans.

Several other government programs designed to prop up the housing market also are in play:

-- **The home buyers tax credit** of \$8,000 for first-time buyers and \$6,500 for repeat buyers expires April 30. Although many experts think the program simply caused people to buy houses earlier than they had planned, its end is likely to cause a dip in home sales.

"Higher interest rates without a tax credit means the cost of buying a home will rise significantly," Zandi said. "We should expect much weaker home sales in May, June and July."

Cecala thinks that if home sales are anemic, Congress may extend the tax credit an additional six months, as it's already done once before.

-- **Federal Housing Administration loans**, an increasingly important source of financing for many borrowers, especially those with low and moderate incomes, imposed more stringent lending criteria in January. As FHA delinquencies rise, the rules could tighten still more, eliminating some potential buyers.

"The FHA portfolio has all sorts of bad debt in it," Thornberg said. "Eventually they'll have to pull back" on lending.

-- **Home Affordable Modification Program**, the government-backed plan to get banks to help troubled homeowners, has kept the market from being flooded with foreclosures, as hundreds of thousands of borrowers are negotiating with their lenders for lower payments. Eventually, observers say,

much of that backlog will wind up in foreclosure because homeowners simply don't have the income or ability to make modified payments. A new surge of bargain-basement foreclosures would undermine home prices.

"We have a boatload of homes that ultimately will find their way to a foreclosure sale, and that will put pressure on house prices," Zandi said. "The more that distressed home sales rise, the more home prices get pushed down."

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