Mortgage rates lower, too? Not so fast

By Holden Lewis

Yes, the Federal Reserve cut short-term rates. No, that doesn't mean that mortgage rates will inevitably go down, especially in the short term.

A look at mortgage rates must begin with a history lesson. From Jan. 3, 2001, to June 25, 2003, the Federal Reserve reduced its target for the federal funds rate 13 times. Here's what happened to the average 30-year mortgage rate in the month after each cut: It fell eight times and rose five times. It's simply not true that a Fed rate cut automatically leads to a drop in fixed mortgage rates.

Because this point is so widely misunderstood, mortgage people wax passionately about it. Such is the case for Dan Dowling, president of United Mortgage Capital Corp., in Altamonte Springs, Fla., who declares emphatically, "There is zero causation between mortgage rates and the Fed reducing its target for the federal funds rate."

Whenever the Fed cuts the federal funds rate, customers call mortgage lenders, eagerly expecting to take advantage of a drop in mortgage rates. By the time these phone calls are over, customers frequently feel disappointed and even suspicious. It just doesn't seem right. Why would banks raise mortgage rates while the Fed is cutting rates?

Things aren't that simple (or that sinister). Mortgage rates go up and down according to investors' expectations of long-term inflation. Simply put: If investors think inflation will accelerate, mortgage rates (and other long-term interest rates) rise.

The nation's overall economy doesn't appear to be in recession (although the housing sector, and some Midwestern states, might be). Yet the Fed added some stimulus by cutting the federal funds rate. That, in turn, could lead to faster-rising prices and, therefore, higher long-term interest rates.

What mortgage rates portend

Mortgage rates often anticipate Fed rate moves instead of reacting to them. Just two months ago, in mid-July, the average rate on a 30-year, fixed-rate mortgage in Bankrate.com's weekly survey was 6.82 percent. This week, it was 6.32 percent -- exactly half a percentage point lower. And the Fed just reduced the federal funds rate by the same margin of half a percentage point.

Dowling says that when you see mortgage rates declining, they're reacting to market forces -- and the Fed eventually plays catch-up. "The Fed didn't cause the decline (in mortgage rates), which already took place prior to them lowering the rate," he says.

Bob Walters, chief economist for Quicken Loans, agrees that fixed-rate mortgages "priced a lot of this move in." He expects long-term mortgage rates to remain stable, unless the overall economy stumbles. Starting rates on adjustable-rate mortgages will drop, Walters says, because they're more sensitive to Fed rate moves.

From Walters' perspective, the most welcome change will happen in bank-to-bank lending. There will be more of it, which will "un-seize" the jammed credit markets that have made it hard to find a jumbo mortgage in the last couple of months. Jumbo mortgages are home loans exceeding a "conforming limit" that changes annually; this year, the conforming limit is $417,000.

"More people will get loans as a result of this than they could get before this," Walters says.

Dean Baker, an economist with the Center for Economic and Policy Research, in Washington, D.C., doesn't expect much of a break in mortgage rates, either. "Prime mortgage rates may go down a small amount," he says. "But anything that's not prime and conformable -- I'd be surprised if you'd see any downward movements."

Impact on home prices

As Baker sees it, the problem is that house prices have more room to fall. They've already gone down in many markets. Mortgage companies are wary of lending to homebuyers who make small down payments, because those owners could quickly end up owing more than their houses are worth if prices continue to fall.

The Fed's rate cut "is pushing on a string," Baker says. "It's not going to prevent house prices from falling. Housing construction and home sales and house prices will continue to decline."

Everyone knows that some people are harmed when home values fall. Homeowners with adjustable-rate mortgages discover that it's impossible to refinance their suddenly high-rate mortgages when they owe more than their houses are worth.

Home sellers hate it when they end up getting less than they would have if they had sold at the top of the market.

But falling prices create winners, too -- especially when mortgage rates are relatively low, as they are now.

"You have large chunks of the population who stand to gain from falling prices for real estate," Baker says. "As a broad group, you can say everyone who's a renter and might look, at some point, to buy." This especially goes for young people in bubble markets in Florida, California and the Northeast.

Falling prices could benefit Baker, too. He used to own a condo in the District and sold it a few years ago because he was convinced that housing was in a bubble that would burst.

Prices continued rising after he sold, and they've fallen back to around where they were when he sold. But he expects values to fall even further -- and maybe someday he will buy another condo at a bargain price.