Why Fed Rate Cuts Do Not Equal Lower Mortgage Rates

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The Federal Reserve has been on a rate cutting spree once more. 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 during the recent five Fed rate cuts. This is difficult to explain to consumers who have watched a 2.25% reduction by the Fed with very little 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 while a rate set by the Fed can change from one day to another.

It is often said history repeats itself. And if history is any teacher, we can learn from what happened to mortgage rates the last time the Federal Reserve was in a rate-cutting cycle.

The last time the Fed was in a lengthy rate cutting cycle was back in 2001 from January 3, 2001 to December 11, 2001. In the span of 11 months, they cut the Fed Funds rate 11 times with eight of those cuts by 50bp. This resulted in a total of 475bp or 4.75% in short-term interest rate cuts taking the Fed Funds Rate from 6.00% down to 1.75%. Now most uninformed people would naturally think because the Fed cut rates by so much during this time that mortgage rates would follow suit and trend lower as well. Not so. Mortgage rates actually moved higher during this time of significant rate cuts because inflation, the arch enemy of bonds, gradually rose.

Now let’s take a look at what happened with the Fed’s most recent cutting cycle, the first since 2001. On September 18, 2007 the Fed cut the Fed Funds Rate by 50bp. The mortgage bond market briefly enjoyed a “knee-jerk” reaction to the Fed move by closing higher that day, but lost 140bp over the following two sessions. Then on October 31, 2007 the Fed lowered the Fed Funds rate by 25bp. The mortgage bond market responded by losing 78bp over the following five trading days. On December 11, 2007 the Fed once again lowered rates by 25bp and the mortgage bond market lost 88bp in the next three days. So far this year, the Fed delivered a surprise 75bp rate cut on January 22, 2008 and mortgage bonds lost a whopping 144bp in just 2 days. Eight days later and as widely expected, the Fed cut rates by 50bp. Within 13 days from that 50bp cut, mortgage bonds lost 269bp