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Volume 8, Number 1

March 2009

The Great Rate Debate

Media talking heads have been saying it for the last several months, “Interest rates are expected to go down to 4.00% or below”, or “The Federal Reserve is planning to bring interest rates down to... (insert the rate here)”. So why haven’t mortgage interest rates plummeted to these new record lows? The answers may surprise you.

Technically, interest rates SHOULD be around 4.00%. Historically, mortgage interest rates have followed a *general* pattern that is 1.00% to 1.50% higher than the yield on a 10-year Treasury bond, although the two are not directly correlated. The ten year bond yield, as of February 18th, was 2.74%. So one would expect to see mortgage interest rates somewhere between 3.75% to 4.25%. As of the 18th, mortgage interest rates for a primary residence were in the range of 4.75% to 5.25% - depending upon a borrower’s credit score, amount of equity in their home, and the purpose of the loan. The reason for this anomaly is due to the Federal Reserve’s recent purchase of mortgages, market demand, and inflation fears (what?!).

The catalyst to this recent mortgage interest rate reduction was the announcement, back in December, that the Treasury Department would invest \$600 billion to purchase mortgage-backed securities. This unprecedented declaration caused investors to purchase a large number of mortgages. With any bond, when the demand goes up, the price goes up as well — but the yield on the bond goes down. Interest rates are based on bond yields. The direction of mortgage rates are tied to the purchase of mortgage-backed securities.

In January, the Treasury Department announced that they actually began the purchase of mortgage-backed securities, but did not announce any specifics of the plan - only the fact that they would do this through the end of June and possibly beyond. This announcement caused interest rates to go slightly lower. When it was revealed, several weeks later, that they were buying only higher rate bond securities, interest rates actually increased slightly. Investors realized the government was doing nothing to lower interest rates to help the housing crisis. The government was only purchasing bonds that were about to be paid off by the refinance boom. This action essentially keeps a lid on interest rates and allows the Treasury Department to get their money back fairly quickly, but it has done nothing to lower mortgage rates.

Another factor why rates haven’t gone down dramatically is because banks have purposely not passed on lower bond yields to consumers. Because of the real estate market’s demise and generally poor economy, banks laid off tens of thousands of employees over the last 12 months. When interest rates began to drop in December, banks were suddenly deluged with loan applications and caught short handed. Banks had to scramble to rehire, train, and place employees to handle the demand. Because they couldn’t handle the “rush to refinance”, banks purposely offered rates that were higher than what they should be to slow consumer demand.

Since then, economic news has been even more dismal. This has prompted Congress and the new president to prepare a massive economic stimulus package. Because of the new administration’s plan to pump hundreds of billions - and eventually trillions - of dollars into a sagging economy, investors are worried that all this money injected into the economy will subsequently cause significant inflation. Many economists are predicting that the US will see double digit inflation due to the fact that massive spending will cause a sudden surge for goods and services. As demand increases so does the price of raw materials, manufacturing costs, labor, and services.

So how does this affect interest rates? Because investors would be stuck with a low interest rate security that will be useless against inflation (4-5% return vs. 10% inflation - uh oh!), investors will demand a product that will keep up the cost of living. Since mortgage-backed securities offer only a fixed rate of return, they must compete with other investments by increasing their yield to attract investors - which causes mortgage interest rates to rise.

What does the future hold for mortgage interest rates? While no one knows for sure, many economists are predicting that interest rates will probably stay in the 4.75% to 5.5% range until the Treasury Department is done with their mortgage-backed securities purchase plan in June or July. After that, expectations are that interest rates will rise due to the influx of government money into the US economy. Where they go, no one is sure, but if mortgage interest rates do rise significantly, the path to a real estate recovery will be facing a huge road block.

Next Issue: When Does it Make Sense to Refinance?

Is the Recession a Good Thing?

As I bumped along the dusty dirt road, in a jungle area of Mexico, I passed through village after village of third world inhabitants who seemed to be living in an era from long ago. Our tour guide stopped our van at one of the homes to visit a family she knew. We were greeted by small children, a monkey, and roaming chickens.

Though they spoke no English, the children were all smiles. One was cooking tortillas on a primitive grill, another was making a hammock – the family business. Others were doing various jobs around their simple home. There was a wash tub behind the home and clothes scattered about on rocks and bushes. There was no furnace or air conditioner in the thatched roof home. There were no windows, screens or doors – only openings that allowed animals, bugs and the elements to pass back and forth as they pleased. There was no computer, television, iPods, or any other modern technology with the exception of a small radio that

played traditional Mexican music in the background.

It was a stark and humble contrast to my “middle class” life in America.



After we left this little family and continued on our bumpy way, I pondered whether or not my life was unnecessarily complex and hectic. I was longing to live a more simple life that was void of the stress and anxiety that our Mexican hosts were unaware. I envied the simple life of my Mexican friends, so simple and void of stress and anxiety.

As I was contemplating all this, my thoughts began to ponder that maybe the recession is a good thing. I don't mean that in terms of people losing their jobs or companies folding (except for greedy banks and foolish investment companies). This current recession has forced many families to re-evaluate their spending habits, caused them to re-examine their priorities, and simplify their lives to some degree. Is this a bad thing? Isn't our greed and lust for “things” one of the elements that has caused this financial crisis?

People borrowed money when they didn't have the means to pay back. Banks loaned money to people who didn't have a track record for making their payments on time. Companies made products that people really don't have a need for...and paid a lot of money to convince us we can't live without it. Think about it. If you sold or gave away half of the things you own, would your quality of life really be all that much different right now?



We have too much stuff. There are those around us and across the world who have great needs, not wants, but *needs* – prescriptions, medical procedures, food, shoes and clothes, heat, electricity, clean water, you name it.

If we shift our economy and our spending slightly toward meeting needs, and not feeding ridiculous desires (who really needs a Snuggly or a Chia Pet?), simplify our lives, begin to save money and give our time and money towards those truly in need, what would that look like? Yes, there will be a short term “pain” factor as companies who make these products and services close or retool (because of lack of consumer interest), but wouldn't this be the time for that anyway?

Thomas Tusser, a sixteenth century English farmer and writer, coined the phrase, “A fool and his money are soon parted”. If we looked closely at our spending habits over the last few years, I'm sure we would feel rather sheepish toward where we have spent some of our disposable income. Add that up across America and we likely wouldn't be talking about stimulus packages.

Maybe I'm too idealistic, but if we, as a country — the greatest country in the world — were to take our eyes off of ourselves, and focus our money, time and resources toward those less fortunate, maybe we can turn our economy around and meet some real needs here and around the world at the same time.

