TD Bank Financial Group

TD Economics

Special Report

March 5, 2008

U.S. HOMEOWNERS NOT GETTING MUCH OF A BREAK ON MORTGAGE RATES

The Federal Reserve has dished out a heaping spoon full of monetary stimulus – 225 basis points – into the ailing U.S. economy in the past 6 months, but the big question is whether American households are getting the benefit of lower interest rates?

Both the level and change in mortgage rates are largely dictated by the yield curve. Mortgage rates are a spread product from risk-free government money market and bond yields. Since the Federal Reserve started cutting rates in August of last year, the yield on 1-year Treasuries has dropped by about 180 basis points. However, most of that occurred in January and February when the Fed undertook aggressive action on the rate front, slashing the fed funds rate by 125 basis points. 1-year Treasuries mirrored this sharp downward move. At the long end of the curve, the yield on 30-year Treasuries has declined by about 60 basis points since August, but the last two months have brought little change to this rate.

HIGHLIGHTS

- **When it comes to conventional mortgages, much of the 225 basis points in fed fund cuts is not making its way to U.S. mortgage holders.**
- **Subprime reset rates have declined in the past six months, helping to cushion some of the payment shock. But, there is very limited benefit to be had from further fed cuts for these homeowners.**
- **Once the short-lived impact from fiscal stimulus dissipates in H2-08, the U.S. economy could relapse in early 2009 if American households are unable to derive greater benefits from past Fed rate cuts.**

SPREAD BETWEEN 1-YR ARMS AND TREASURIES

Source: Federal Reserve

How much of this drop in Treasury rates has been reflected in U.S. mortgage rates? Not much if you hold a short-term variable mortgage rate. One-year adjustable mortgage rates (ARMs) have declined by only 47 basis points since the start of this year. This amounts to just over one-third the decline of Treasuries, which is not on par with the historical experience. As short-dated Treasury yields have fallen, the spread with the respective mortgage rate has widened considerably. The 1-year spread stood at a massive 309 basis points by the end of February, three times the historical average since the mid-1980s.

Fixed rate mortgages no better

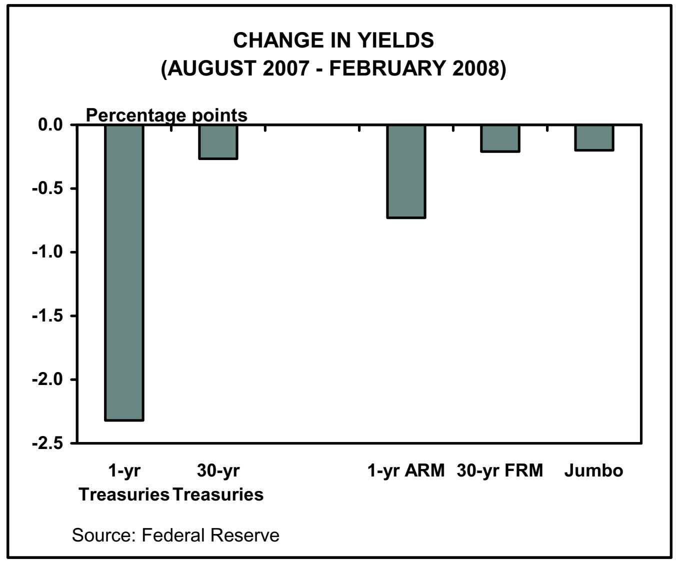
In contrast, the rate spread gap between longer-dated Treasuries and fixed rate mortgages (FRM) is more consistent with historical norms, and there has been greater downward movement in general within these mortgage products. For instance, since August 2007, 30-year mortgage rates have declined 41 basis points, while 15-year mortgage rates have declined 48 basis points. On the surface this is encouraging news, but the recent trend has been highly unfavourable. In the past four weeks these FRM mortgage rates have backed-up by 55-56 basis points, eroding a good chunk of the interest rate stimuli that had been accruing.

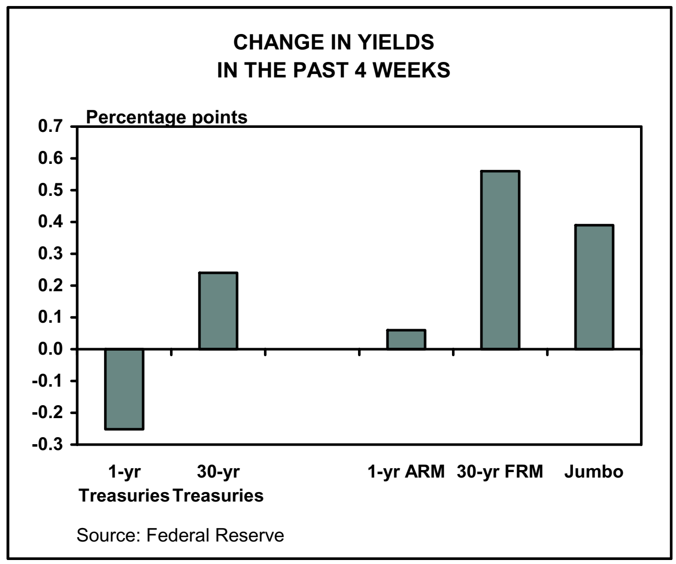
If wide short-term mortgage rate spreads are sustained and the back-up in FRM rates continues, the effectiveness of the monetary stimulus injected by the Federal Reserve will be greatly stunted. It was our hope that lower mortgage rates would give homeowners the incentive to refinance away from higher-rate mortgages. In turn, this would free up some household income, help curtail mortgage delinquencies and possibly cushion the downside to the housing market by providing a floor under prices. In the most optimistic scenario, lower rates could draw new mortgage demand into the market, though it is hard to imagine there's much in the way of pent-up demand or available first-time buyers.

Looking at the data, mortgage refinancing applications did surge in January as homeowners jumped on the opportunity for lower rates, however that momentum disappeared in February as mortgage rates started to reverse course. In just four short weeks (January 25 to February 22), refinancing applications fell to less than half the peak level and are no different today than what prevailed in the fall of last year, long before the Fed's aggressive rate cuts. In terms of a pick-up in new mortgage demand, don't hold your breath as mortgage applications for purchase received only a modest lift in January and continued to hold at the lowest level in almost five years.

Jumbo mortgage rates get little reprieve

If recent monetary easing by the Fed is having a relatively limited impact in pushing down conventional mortgage rates, which is where homeowners with good credit scores fit in, it's a good guess that the situation is worse among the most vulnerable homeowners – those with subprime, Alt-A or jumbo mortgages. Jumbo mortgages apply when the principal amount of the mortgage of the prime borrower exceeds the underwriting limits allowed by government sponsored agencies (Fannie May and Freddie Mac). Up until February of this year, that limit was $417,000.[1] Alt-A involve loans to borrowers with good credit, but include more aggressive underwriting than the conforming or Jumbo classes (i.e. no documentation of income, high leverage). The subprime asset class involves loans to borrowers with poor credit history.



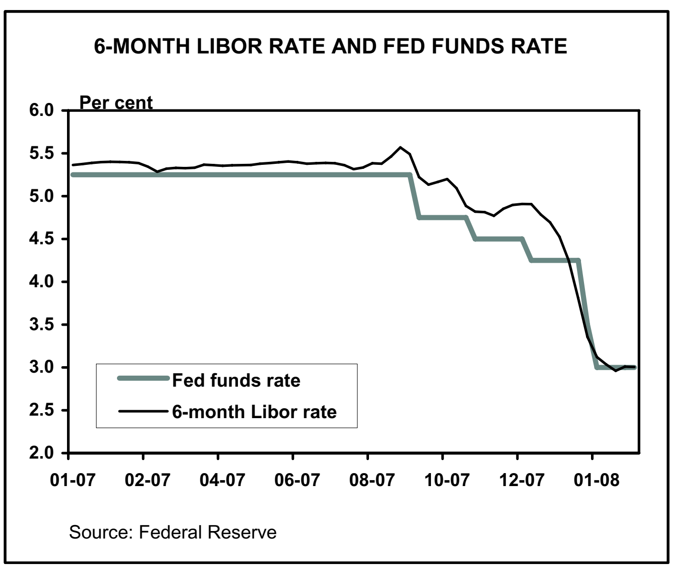


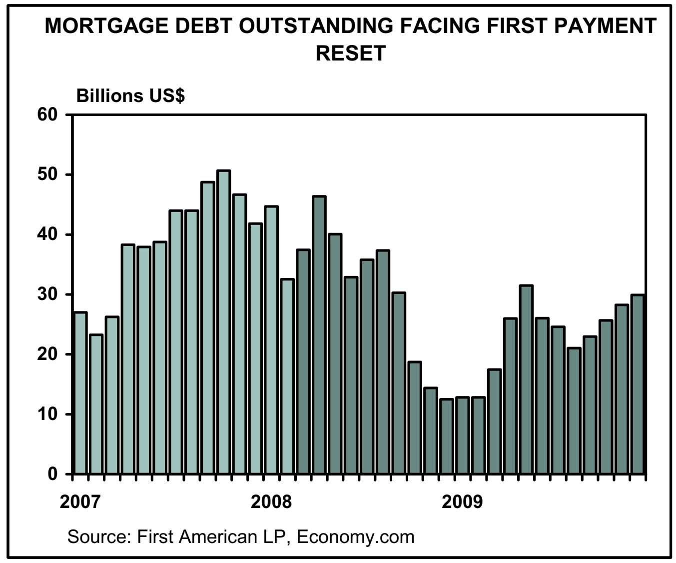
In the jumbo category, heightened aversion to risk among financial institutions has resulted in a sharp back-up in mortgage rates to the tune of 40 basis points in the past four weeks. As a result, jumbo rates have only fallen by a total of 20 basis points since August, which is a drop in the bucket relative to the amount of Fed easing that has taken place. As of February 27, the average jumbo rate was 7.11%, more than a full percentage point above the prime rate and two full percentage points above 1-year ARMs. In fact, relative to the first half of 2007 when the fed funds rate sat at 5.25% (as opposed to 3.00% today), the average jumbo mortgage rate is 81 basis points *higher*.

Subprime reset rates have fallen

Although it is well known that the level of subprime rates is high, some might find it surprising to learn that these mortgages have been resetting at lower rates than was the case six months ago. While the terms of a subprime mortgage depend on the type and the year of issuance, one basic principle holds: once the 'teaser' rate on these mortgages comes to an end after two or three years, the mortgage rate resets to a market rate plus a minimum margin rate for the remaining life of the mortgage. For the common 2/28 and 3/27 subprime mortgages, the 6-month Libor rate is used as the market rate. The margin to be paid on top of this rate varies, but a range of 6-6.25% is a reasonable estimate for issuances during the 2004-2006 period. The mortgage interest rate is updated every 6 months for the life of the loan, so a subprime mortgage holder is not locked into a single rate once the initial reset takes place.

The 6-month Libor has fallen 236 basis points since August or 169 basis points since the start of this year. By extension, the subprime reset rates have reflected this drop. Anyone who had to reset their subprime mortgage rate in the summer of last year now has the benefit of a much lower reset rate in accordance with the Libor. However, the absolute level of these mortgage rates still remains quite punitive (we estimate at about 9.25%) and there is limited scope for further improvement.





Subprime loan contracts build in floors for rates (i.e. a level in which the mortgage rate cannot fall below). In a New York Federal Reserve paper that looked at a particular pool of subprime mortgages originally issued by New Century Financial between the years 2004-2006, the average floor rate for 2/28 ARMs was 8.64%. Once the floor is hit, it doesn't matter if the Libor rate pushes lower because the mortgage holder will no longer receive the benefit of the downward movement. Therefore, there are limitations that a lower fed funds rate can provide to these high-risk borrowers.

Also, the downward movement in reset rates does not detract from the fact that payment shock continues to exist. A December 11, 2006 presentation by Fannie Mae reported that 2006 subprime ARM loans in mortgage-based securities carried an average initial interest rate of 7.95%. Hence, resetting to 9.25% is still a 16% payment shock in interest costs. However, six months ago, that payment shock would have been an increase of 44%.

Conclusion

There are two messages that come out of this report. First, conventional mortgage rates are not capturing the degree of stimuli suggested by the sharp drop in the fed funds rate. Simply put, it does not appear that much of the 225 basis points in fed fund cuts is making its way to mortgage holders. Should this continue, a sustained U.S. recovery could be delayed beyond our current expectation.

The $168 billion in fiscal stimulus that will be doled out will surely provide a lift to economic growth the second half of this year. However, once this short-lived impact dissipates, the U.S. economy could relapse in early 2009 if American households are unable to derive greater benefits from the longer term influence of past Fed rate cuts.

The second message is that the most vulnerable of homeowners in America are catching a break on the mortgage front; however the real impact on the economy may not be sufficient to pull the U.S. out of the doldrums. Subprime mortgages make up only 15% of all outstanding mortgages, so it is a group that is in the minority and unlikely to be the main driving force behind a convincing economic rebound. And, perhaps more importantly, the benefit of a further reduction in the fed funds rate (and thus libor rates) is nearing a floor, so the Fed can offer only modest assistance to subprime mortgage holders from here on in.

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Endnotes

1 President Bush temporarily raised the conforming limit to $729,750 until December 31, 2008.