Mortgage Rates Seen Below 3% With Fed Buying Low-Coupon Bonds

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(Bloomberg) -- Traditional 30-year home loans with rates below 3% are inching closer as the Federal Reserve works to stimulate the U.S. economy.

The Federal Reserve Bank of New York bought contracts for $240 million of mortgage bonds with a coupon of 2% on Monday, the first time it's ever purchased mortgage securities promising to pay so little interest, according to a Fed spokeswoman.

The move suggests lenders could easily sell mortgage loans at rates below 3% to Wall Street investors, a key step in pushing down borrowing costs that already are near historic lows.

And the Fed isn't finished with the low-coupon securities. The central bank has said it will buy more this week as part of $20 billion in planned securities purchases, virtually guaranteeing a buyer for recent 30-year mortgages with rates as low as about 2.5%.

Fed Impeded

Interest rates on traditional 30-year mortgage loans have stayed above 3% in recent months, despite a sharp fall in benchmark borrowing costs. While the yield on the 10-year Treasury note has dropped 1.2 percentage points since the start of the year, for example, mortgage rates offered by lenders have fallen by less than half that amount.

That's impeded the Fed's effort to buoy the economy with cheap credit. The purchases Monday of lower-coupon mortgage securities should help, according to Satish Mansukhani, who leads a team of mortgage researchers at Bank of America Corp. He estimates that 30-year mortgage rates could fall to around 2.5%.

Some lenders cautioned that while rates for home loans will drop in the coming months, the mortgage industry isn’t ready for a flood of applications from borrowers wanting to pay less than 3% annually, especially with job losses mounting.

“The government can do all they want, but lenders still make mortgage rates,” said Chris Fox, owner of St. Louis-based F&B Financial Group, which originated about $325 million of mortgages last year.

Burst of Buying

Lenders sell most of the home loans they originate, and the bulk of those end up in securities issued by government-owned mortgage giants Fannie Mae and Freddie Mac. The securities typically offer yields around 50 to 100 basis points lower than what borrowers pay on their 30-year mortgages, taking into account various fees. That means a bond offering 2% typically will contain loans to households paying 2.5% to 3%.

Some mortgage analysts and advisers had predicted it would be another few weeks before the Fed would buy home loan bonds with coupons of just 2%. But there was a burst of activity on Friday, according to data tracked by Mansukhani.

Since March, when the Fed unleashed a wave of stimulus in response to the coronavirus, the central bank has bought $628 billion of mortgage bonds issued by Fannie Mae, Freddie Mac, and the government agency Ginnie Mae, central bank data show, with nearly two-thirds of that concentrated among 30-year bonds with coupons of 2.5% and 3%.

Long Time

Vishal Garg, chief executive officer of Better.com, a home-lending startup backed by Citigroup Inc. and Goldman Sachs Group Inc., said the Fed’s purchases of 2% bonds were a good step toward lower interest rates for households. Still, he said it will take “a long, long time” before banks and investors broadly fund easily attainable 30-year mortgages for less than 3%.

Many lenders and mortgage buyers are cautious because of the worsening U.S. economy, especially after the U.S. Department of Labor announced Friday that an unprecedented 20.5 million jobs were lost in April, Fox said.

“It’s great that rates are so low, but do you as a lender want to be aggressive with unemployment at these levels?” said Fox.