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MY TAKE

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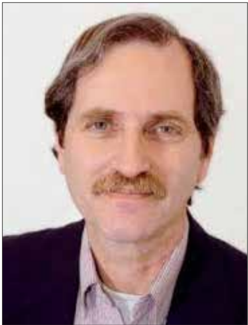
Will Mortgage Rates Fall In 2016?



Here we go again, another year lies ahead and with it the widespread view that mortgage rates will surely climb. After all, the Federal Reserve has started to increase the rate banks pay to borrow funds overnight and the economy seems stronger so it seems logical that mortgage rates will follow.

But — just maybe — it's wise to not jump on the higher-rates bandwagon. Faithful readers will remember our mortgage rate prediction at the start of 2015: While others were forecasting rates of 5 percent and more, we said "looking at current predictions the sense here — for what it might be worth — is that 2015 will surprise us all. It's entirely possible that rates will largely stay where they are and perhaps even fall."

And that, in a nutshell, is what happened.

Fixed-rate 30-year prime mortgages were priced at 3.87 percent at the end of 2014 and 3.96 percent for the week of December 24, 2015, according to Freddie Mac. During the year the low was 3.59 percent in February while the high was 4.09 percent in July. The February rate was not far from the all-time low, 3.31 percent in 2012.

Let's once again stir some tea leaves and suggest how the mortgage market will look in the coming year — and why. There are no guarantees, but the reasoning and facts behind the 2015 forecast tell us a lot about what may happen in 2016.

First, we made the argument last year that negative interest in Europe and Asia meant vast amounts of capital were available to underwrite U.S. mortgages. With so much supply and relatively little demand how could mortgage rates go up? This turned out to be entirely true — there is some $3.6 trillion invested worldwide with negative interest and the U.S. banking system is flooded with $2 trillion in excess capital so it's not surprising that U.S. mortgage rates remained close to historic lows for the entire year.

Second, economic contraction coupled with warm weather and more high-mileage vehicles have combined to substantially reduce oil demand. This is a huge problem for energy producers — and a delight for consumers who have watched gas prices tumble throughout much of the year. The result is more disposable spending in an economy where 70 percent of our gross domestic product depends on consumer purchases.

Changing energy production has begun to significantly — and permanently — impact oil pricing.

For instance, we may have as many as 4 million solar-powered homes by 2020 and today almost 10 percent of our energy consumption comes from renewable sources, 40 percent in California. This is good but we can do much better — Scotland already produces enough energy from wind power to electrify its entire housing stock. Once renewable energy production is in place there is no incentive to shut it down — the capital expenditure to set it up has been made and the fuel is free.

What's surprising about renewable energy is that one would logically expect solar and wind installation activity to decline when oil and coal prices are down but that has not been the case. According to *The Washington Post*, "orders for 2016 solar and wind installations are up sharply from the United States to China to the developing economies of Africa and Latin America, all in defiance of stubbornly low prices for coal and natural gas, the industry's chief competitors."

Third, in our 2015 projection we noted that the Fed was likely to raise interest rates — but if it did, the impact on mortgage pricing would be minimal. The Fed almost made it through the year without an increase and when it finally did raise bank rates not much happened on the mortgage front. While the Fed sets bank rates by committee, mortgage rates respond to market pressures — and for 2015 there was hardly any pressure to raise rates.

2016 Mortgage Rate Prediction

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The Mortgage Bankers Association predicts that mortgage rates in 2016 will hit 4.8 percent while the National Association of Realtors sees mortgages reaching 4.5 percent by the end of the year.

These are conservative forecasts which suggest that mortgage rates will be nowhere near 8.6 percent, the general average going back to the Nixon presidency. That said — and for what it might be worth — as we look toward 2016 we see mortgage rates that will remain relatively flat for most of the year. Indeed, let's go out on a limb and suggest that even lower rates are possible.

Why is it that mortgage rates are unlikely to have much zip in 2016?

In December, the European Central Bank lowered its interest level for banks to -0.3 percent and negative interest remains a fact of financial life for much of the world. And yes, lower rates — and even negative interest — are possible in the U.S. Fed Chairman Janet Yellen actually broached the idea in November, saying in congressional testimony that if the economy slowed then "potentially anything — including negative interest rates — would be on the table."

Prior to December, the Fed had been saying that it would raise overnight borrowing costs for banks and credit unions as soon as unemployment fell below 6.5 percent and inflation topped 2 percent. What actually happened is this:

In 2014, when unemployment finally dropped below 6.5 percent the federal funds rate did not go up. The Fed explained that their prior guidance — the guidance upon which Wall Street, Washington and investors depend — was simply "outdated."

In December 2015, the Fed raised bank rates even though the rate of inflation remained below 2 percent. As Yellen explained, the Fed "was reasonably confident that inflation would move back to its 2 percent objective over the medium term." In other words, the Fed raised interest costs even though inflation was not at 2 percent or above, again reneging on prior guidance.

Immediately following the Fed's December rate announcement, the major banks instantly increased prime loan rates from 3.25 percent to 3.5 percent.
What about savers?

As *USA Today* explained, "banks did not, however, increase interest rates on savings accounts or certificates of deposit, nor should consumers expect to see any increases on deposit products in the near future."

Why shouldn't savers see higher rates?

The Fed has now set in motion several huge problems for 2016.

First, 2016 is an election year. Many people feel that Washington is not responsive to them. Whether one agrees with such views or not, what better evidence could you have than a rate increase, which benefits banks but not savers? This is easy stuff for the public to see. And resent.

The prime rate will rise with any additional Fed hikes, which will occur in 2016, should any increases occur. Savvy bankers can then quote the prime rate while borrowing overseas at below-Fed costs and pocket the difference. This is an obvious way to boost bank profits, especially if savers and depositors do not benefit from rising rates. However, if this happens — and if the public finds out — there could be a substantial price to pay in terms of public opinion, an opinion that may resonate on Capitol Hill in an election year.

Second, it is widely predicted that there will be several more rate increases from the Fed in 2016, but in practice the Fed has thrown the dice, gambling that a rate increase will help the economy or at least not damage it.

Unfortunately, this gamble could be very wrong. As *The Washington Post* points out, "Europe, Japan and Sweden all did (it) in recent years, and, as a result, all of them ended up back where they started — zero — soon thereafter." (Parenthesis mine.)

Third, having raised rates for the first time since 2008, the Fed now risks the possibility of massive reputational damage.

Banks borrow money overnight at rates set by the Fed, but what if they can get cheaper money elsewhere? Think of the trillions of dollars at negative interest now looking for a better return. Why borrow from the Fed when rates are lower elsewhere, borders don't count, and funding is just an electronic blip away?
The Fed benefits from a perception of power and authority

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but if banks can go elsewhere for cash at bargain rates than the Fed's power will be eroded. As Alan Binder, a former vice chairman of the Fed's Board of Governors explains, "when the Federal Reserve, or any central bank, pushes its rates close to zero, its power to boost the economy ebbs — not ends, but ebbs."

Fourth, Fed actions do not directly impact mortgage rates. The Federal Reserve Bank of New York points out that mortgage rates largely reflect Treasury yields and not the federal funds rate, arguing in effect that the Fed is already irrelevant in the mortgage marketplace. This argument should be enormously comforting to borrowers who want to finance and refinance real estate because it suggests that cheap money will keep flowing into the housing sector in 2016, especially through nonbanks which play a larger and larger role in the mortgage financing system and cannot borrow from the Fed.

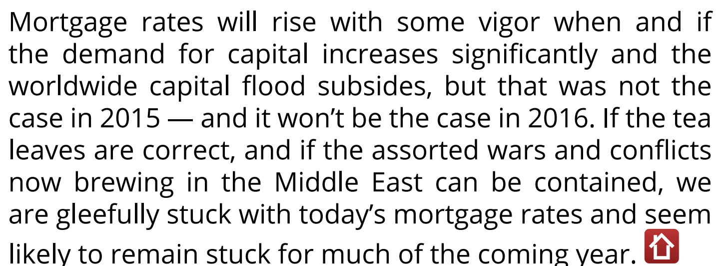
If we look back at 2015 the major issues were a possible Fed move, lower energy costs and cheap financing from abroad. As we have seen, cheap money from overseas continues to be a reality. The Fed has hiked rates and the result is largely irrelevant for mortgage borrowers. Energy costs fell during 2015 and without a robust and recovering world economy they're likely to stay that way in 2016 and beyond.

Unfortunately, there are other reasons why mortgage rates are destined to stay low. The economy, while recovering, is not recovering for everyone. Much of the population is not sharing in our better times; household income remains substantially below what people earned in 1999 and with inflation are unable to keep up. As an example of distorted incomes and costs, in Massachusetts the city of Cambridge is setting aside apartments with below-market rents for impoverished local citizens — those making as much $118,200 for a family of four.

The result of contracting incomes is that housing demand is hardly robust: In November the National Association of Realtors reported that existing home sales for the year were lower than in 2014 — and home sales in 2014 were lower than in 2013.

Mortgage rates will rise with some vigor when and if the demand for capital increases significantly and the worldwide capital flood subsides, but that was not the case in 2015 — and it won't be the case in 2016. If the tea leaves are correct, and if the assorted wars and conflicts now brewing in the Middle East can be contained, we are gleefully stuck with today's mortgage rates and seem likely to remain stuck for much of the coming year.

Peter G. Miller is a real estate broker and the author of several books in the field, including Buy Your First Home Now; Successful Real Estate Investing; How to Sell Your Home in Any Market and The Common Sense Mortgage. He is also a syndicated columnist in over 140 U.S. newspapers. He blogs at www.OurBroker.com.



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