

# DIVIDENDS

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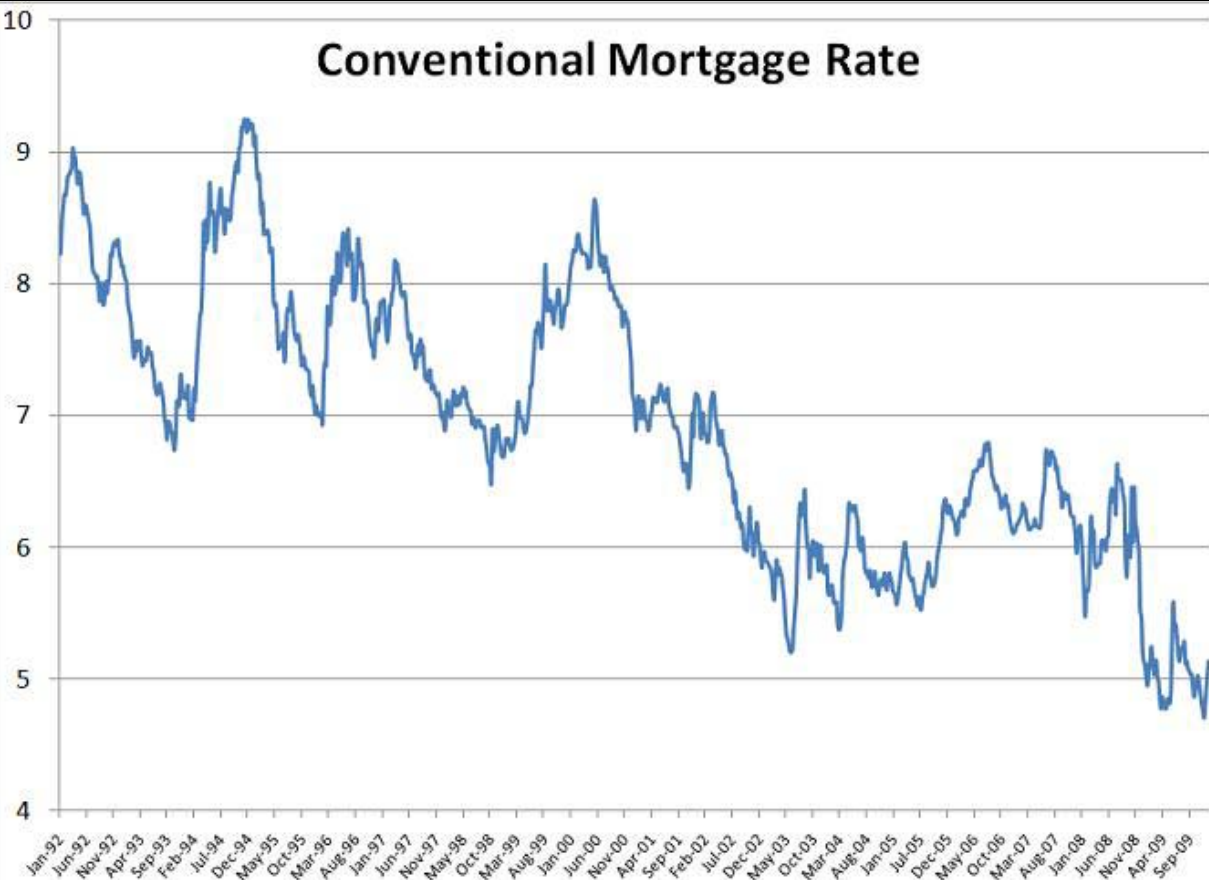
February, 2010

Anyone who has celebrated at least three or four dozen birthdays has probably participated in the time-honored boastful conversation that starts with "I remember when I bought my first home, the interest rate was (insert double digit interest rate here)".

When mortgage rates dropped into the sub-7.0% territory in 2000, pundits gasped at this temporary anomaly. Ten years later, it is apparent that the residential lending rates have changed to more stabilized lower rates. The median rate on a 30-year conventional loan from 1992 - 2000 was 7.67%. From 2000 until today, the median rate is 6.18%. **One and a half percent may not sound like much, but for the same monthly payment, the purchasing power of the buyer is increased by 24%.**

The story behind residential mortgage rates belies what is truly the pressing issue in the housing market for a buyer. The price of a home in San Diego should really **not** be the motivating factor for a buyer - the monthly payment that the purchase equates to is really what stimulates the buyer. Need proof? People were not buying \$1.2 million homes in Chula Vista in 2004 because they thought they had timed the market perfectly and the price was right, they were buying \$1.2 million homes in Chula Vista because they could get 98% financing with a seemingly reasonable payment that at the time was financially feasible for them - they were maximizing the utility of their dollar.

## Conventional Mortgage Rate



There are few topics that generate as much conversation as the direction of mortgage rates. The problem is that starting at the turn of the millennium; the predictability disappeared in mortgage rate forecasting.

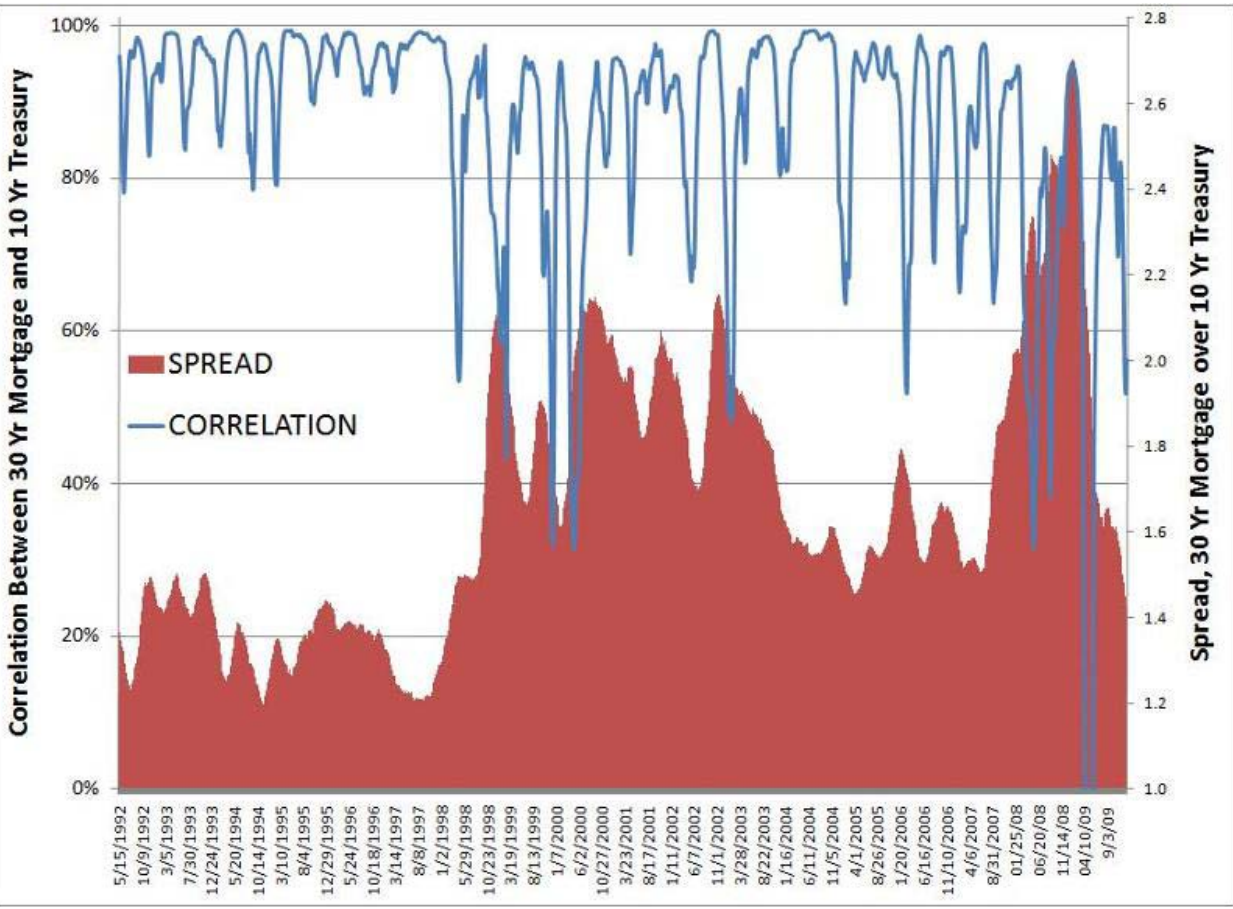
Economics 101 says that the U.S. 30-year conventional mortgage rate is directly tied to the nominal yield on the 10-year U.S. Treasury. The chart below shows that the correlation between mortgage rates and the 10-year Treasury stayed above 80% for most of the 1990s; consequently the spread remained at approximately 120 - 150 basis points. What that demonstrates is that during periods of economic calm mortgage rates behave in tandem with the 10-year Treasury.

The problem with applying this theory over the most recent decade is that there really is no longer such a thing as "economic calm". If interest rates are being artificially handicapped, if the demand for securitized mortgages changes drastically, if there is any unrest in the global economy as a whole, or if the federal government is altering its normal issuance of Treasuries, than there is no reason to expect mortgage rates to behave in a rational manner with the 10-year treasury. At least one of the above mentioned actions has been occurring over the last decade.

As noted on the graph below, *correlation* has dropped to 35-40% at times, even going negative at one point - an unheard of concept where the yield on a 10-year treasury was inversely reacting with a 30-year mortgage rate.

The economic theory behind the *spread* increasing in times of general economic distress is simple: investors of mortgages demand a risk premium for investing in "risky" assets in time of turmoil. During the global

currency/bond crisis of 1998, the tech bust of 2000, and the beginning of the current recession, we see the spread for mortgage rates peak to 200 basis points - a rational reaction from investors as the infamous flight to quality occurs.



What does this mean for the retail buyer who is thinking of buying a house? It means two things: first, guessing where mortgage rates will be in a year or two is an uneducated guess at best. Secondly, given the impact of small changes in rates affecting massive amounts of buying power, renting money at or near 5% is a proposition one shouldn't pass lightly.

Waiting for the average price of homes in a national home index to rise by 5% only to discover that the ½ percent increase in mortgage rates has dropped 10% of their buying power, is like playing keno in the casino cafe - you're only going to lose money.

While the media and general public is compulsively obsessed with housing price indexes, market timing and identifying the nadir of the local housing market, the truth is that buyers should be focused on their ability to obtain long-term financing at the bargain basement rates that have become so common place in the last decade.

Considering the uncertainty of where these rates are heading, who knows, maybe in 25 years the chic conversation starter will be, "I remember when I bought my first house, my mortgage rate was *only* (insert low single digit rate here)".

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