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Epic Knowledge Drop on Why Mortgage Rates Can Appear to Have Dropped by Near Record Amounts Recently

When rates jump by some of the biggest amounts ever to the highest levels in more than a decade, it sets us up for some equally impressive corrections when the underlying bond market finally finds its footing. That happened last week in grand fashion following the Fed announcement.

From Tuesday morning to Wednesday afternoon, rates dropped more than on any other single day since we began keeping daily records in 2009. In many cases, this amounted to a drop of 0.375% in terms of conforming 30yr fixed rates, although the average was "only" 0.25%.

Today's drop versus yesterday is "only" 0.19%, but that's still one of the 5 biggest day-over-day drops we've recorded. Once again, certain scenarios at certain lenders are seeing a drop of as much as 0.375%.

What's up with the difference between those instances of 0.375% and our 0.19% average? First off, one is an average, and not every scenario has improved by that much. Secondly, and more importantly, this has to do with that potentially confusing point I've been making almost every day for the past few weeks about the "buydowns" between rates being much smaller than normal.

Because this is a somewhat complex topic depending on you level of familiarity, let's take a moment to break it down.

Mortgage Rates: Upfront Cost vs Cost Over Time

Mortgages have 2 costs, whether you can see both or not. One of those costs is obvious. It has to do with the interest rate. The higher the rate, the higher that cost. You will pay it over time in the form of monthly payments.

The other cost is paid (or credited) upfront. This can take the form of origination fees, "points" (i.e. discount points), underwriting fees or other lender fees--any costs required by the lender in order to obtain the loan.

National Average Mortgage Rates



Mortgage News Daily	Rate	Change	Points
30YR Fixed	7.34%	+0.01	0.00
15YR Fixed	6.89%	0.00	0.00
30YR FHA	6.96%	+0.01	0.00
30YR Jumbo	7.45%	+0.01	0.00
7/6 SOFR	6.83%	+0.02	0.00
30YR VA	6.97%	0.00	0.00

Rates as of: 11/23

MBS and Treasury

	Price / Yield	Change
MBS UMBS 6.0	99.57	+0.06
10 YR Treasury	4.9397	-0.0006
30 YR Treasury	5.3032	-0.0292

Pricing as of: 11/23 1:16PM EST

Recent Housing Data

		Value	Change
Mortgage Apps	Nov 11	199.8	-2.35%
Building Permits	Oct	1.3M	-7.5%
Housing Starts	Oct	1.31M	+7.21%
New Home Sales	Sep	676K	-1.17%
Pending Home Sales	Oct	63	-4.69%
Existing Home Sales	Oct	3.99M	+0.25%
Builder Confidence	Nov	25	-13.79%

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There is never only one interest rate available to you. While not every lender may offer an array of available rate options, they could if they were so inclined. Higher rates would have lower upfront costs and vice versa. Go with a high enough rate, and the loan is profitable enough to the lender that they can actually pay their normal upfront costs for you. This is where a "no closing cost" loan becomes possible (but keep in mind that definitions differ on what that really means. Some lenders are referring to lender-related costs while others will let you jack the rate up high enough to pay other upfront costs as well, like title/escrow/etc).

The ability to offset upfront costs with higher rates depends on the value placed on mortgage loans by the financial market. Remember, these loans will ultimately become bonds that are traded by investors.

Investor appetite for certain loans with certain rates can change. For instance, if the rates are very high, investors expect homeowners to jump at the first chance to refinance to a lower rate. That investor will be cautious about buying too many of those higher rate loans because if they refinance too soon, the lender loses profit.

In fact, an investor may even have paid so much for a higher rate loan that they will LOSE money if that loan refinances in the first few months. This is one reason a mortgage lender may be hit with a penalty from the investor in the case of an EPO or "early payoff."

With all that in mind, now is one of those times where investors are generally cautious about paying too much for higher rate loans. This not only limits the amount of upfront costs that can be soaked up by opting for a higher rate, it also creates irregular gaps between adjacent rates in terms of upfront costs.

The reason for this is quite esoteric unless you're a student of the mortgage bond market (MBS or 'mortgage-backed securities), but it has to do with the rules that govern which loans can be assigned to which MBS.

We're almost out of the esoteric woods, but just stick with me for the last part. It is the scariest and most esoteric.

MBS come in different coupons. A coupon is a rate. It tells investors how much an MBS will pay just like any other interest rate or bond yield. Different MBS coupons have different prices. The combination of the price and the coupon can be plugged into an equation to determine the actual rate of return for an investor.

In general, an investor pays more for a higher coupon. They give up more money upfront in exchange for the right to receive higher payments over time.

MBS coupons are broken out in 0.5% increments (i.e. 4.0, 4.5, 5.0, etc). Any given coupon is like a bucket that can hold loans that are between 0.25% and 1.125% higher than the coupon. That was the confusing part. If you understood that, you're home free.

In other words, if your loan has a rate of 6.125%, it can end up in an MBS of 5.0. But a loan with a 6.25% rate would have to go in a 5.5 MBS coupon because it is more than 1.125% above the 5.0 coupon.

Now we get to the thesis. Remember how we said investors were a bit worried about higher rate loans paying off too quickly? The catch is that investors aren't thinking as much about individual loans as they are about MBS coupons. In this environment where rates have risen so much that the expectation is growing for a ceiling/correction, lenders place a higher than normal relative value on the LOWER of any two adjacent MBS coupons.

In other words, they'd rather have 5.0s than 5.5s. They'd rather have 4.5s than 5.0s. This preference remains intact for all of the coupons that are currently applicable to available mortgage rates.

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THE BOTTOM LINE: what this ultimately means is that a mortgage rate that slots into a 5.0 bucket has more relative value than one that slots into a 5.5 bucket. The valuation difference is so pronounced right now that most lenders have LOWER upfront costs on a 6.125% rate compared to a 6.25% rate. Same story at 5.625% vs 5.75%. That means the overall cost to buy your rate down from 6.25% to 5.625% is about as low as it ever gets.

The even bottomer bottom line: the bond market and other interest rates haven't really moved as much as these record-setting days in mortgage rates would suggest. And depending on the lender, your specific rate quote may not have dropped anywhere near this much, but for certain borrowers who were quoted certain rates at certain lenders, you could be seeing a huge change from yesterday, or compared to last Tuesday.

The Orlicki Group is one of the leading resources for your mortgage needs.

As a licensed mortgage originator I work hand-in-hand with homebuyers and homeowners to explore and secure or refinance loans that suit their needs. Guiding and advising my clients every step of the way, from application to closing, I can help them strategically plan a financially sound mortgage aligned to their long-term goals. Our website also contains some beneficial mortgage tools for you to use. As always this is free information and you should contact us for professional advice if you need it.

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