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A Message from Ted Rood:

"Great take from Matthew Graham of MBS Live on why bond yields (and mortgage rates!) have risen sharply. Spoiler alert: it's not a short term situation."

The Day Ahead: How Did Bonds End Up In This Unfortunate Position?

"Perfect storm" is an overused term, and there other, **more colorful** descriptors I'd use to describe the storm that's been battering bond markets for the past year and a half.

This particular storm began with Brexit failing to bring about the collapse of the global monetary system and failing to serve as a catalyst for another downward cycle in the European economy. Granted, that wasn't the **only** thing markets were focused on, but it was a turning point for bonds and rates. It began a slow, steady move back toward higher rates after 10yr yields hit all time lows in June 2016.

That slow, steady move **could easily have continued** had Hilary Clinton won the US presidential election. Traders would have been focused on the several of the same things that are currently pushing rates higher. These include the generally good economic numbers at home and abroad as well as the tighter monetary policy those numbers imply.

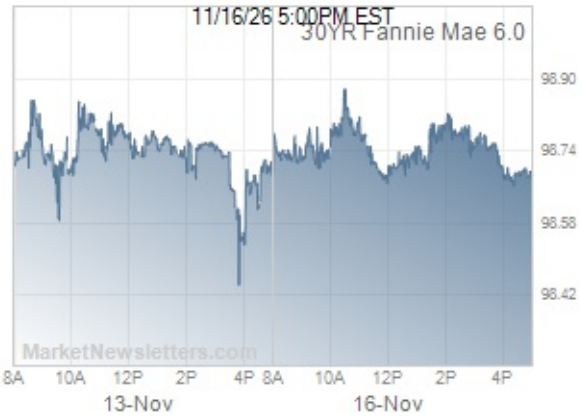
Trump's presidential victory kicked the storm into **higher gear** because it added precisely the opposite of what bond markets would have needed to maintain lower rates. Talk of stimulus and a tax bill suggested higher bond market issuance, and any potential positive economic effects from those policies would only reinforce the "growth/tightening" narrative in the previous paragraph.

For the record, the fact that the president's political party controlled both chambers of congress is just as important--if not more so--than the president himself. Much of this damage could have been done if democrats controlled both chambers and Clinton had won. In either case, it's **easier for lawmakers to spend taxpayer money**--something that increases bond issuance and drives rates higher.

MBS and Treasury

	Price / Yield	Change
MBS UMBS 6.0	98.72	+0.02
10 YR Treasury	5.1286	-0.0056
30 YR Treasury	5.4758	0.0000

Pricing as of: 11/16 7:40PM EST



Average Mortgage Rates

	Rate	Change	Points
Mortgage News Daily			
30YR Fixed	7.51%	+0.01	0.00
15YR Fixed	7.04%	+0.01	0.00
30YR FHA	7.08%	+0.03	0.00
30YR Jumbo	7.52%	+0.02	0.00
7/6 SOFR	7.12%	-0.01	0.00
30YR VA	7.10%	+0.03	0.00

Rates as of: 11/16

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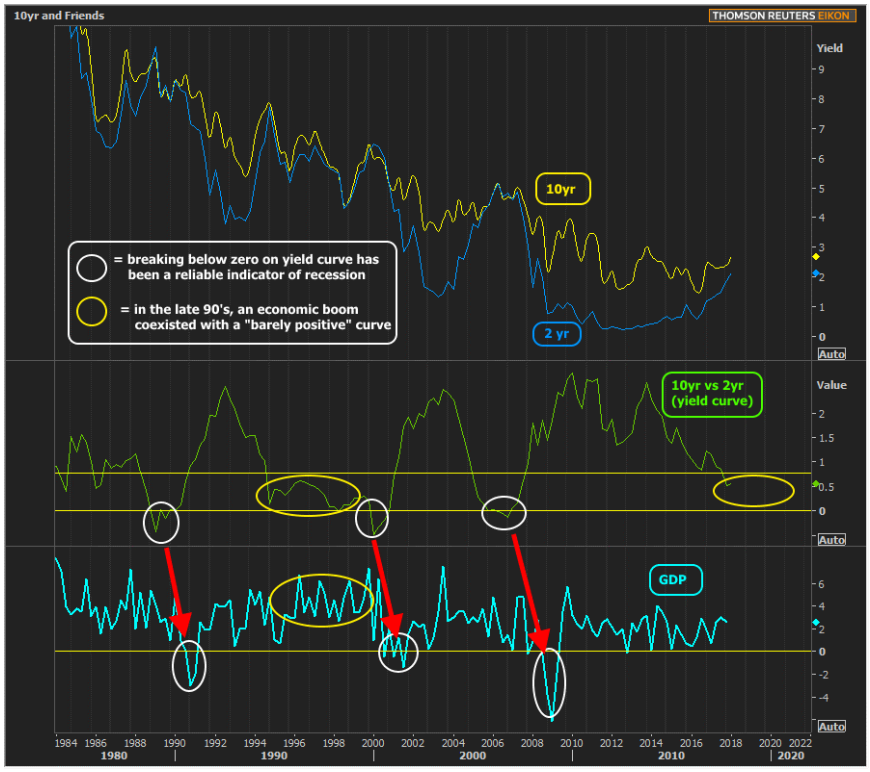
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The middle of 2017 brought doubts about the legislative piece of the narrative. Failure to slam through the initial tax reform bill gave way to failure on healthcare reform. Investors were hesitant to sell longer-term bonds because the long-term growth and inflation outlooks were questionable. Super weak inflation data in the middle of the year only reinforced that stance. The **only logical bet** in bonds was to sell shorter-term debt. That would be the first thing to rise if the Fed continued its hiking trend and that would be the first place the government would increase issuance on the chance it began to pass legislation.

By late September, a new, **more threatening** tax bill emerged. Inflation data had stabilized. The Fed's rate hike outlook had ratcheted to an even quicker pace versus June's numbers (despite inflation headwinds). From there, the 4th quarter saw a progressive pricing-in of the tax bill's price. Thankfully, the Treasury said that impending revenue needs would first be met by increasing issuance in shorter-term bonds. This kept much of the damage contained in 2yr yields and is part of the reason they've performed so poorly against 10s (the other part being the Fed's policy stance).

When 2yr yields are rising and 10yr yields are holding steady, the spread between the two (green line in the chart below) moves closer and closer to zero. This is called an **"inverted yield curve,"** and has historically been an accurate predictor of recessions (white circles in the chart). Even though some Fed speakers have said "this time will be different," I view that as lip service. Economies simply don't grow well without some form of premium between longer and shorter-term debt.

All that having been said, economies certainly **can** grow with **SOME** premium between the two. We saw a massive example of this in the mid-to-late 90's--one the best, most stable expansions on record and the lowest/tightest period of stability in the 2's vs 10's curve in recent memory (yellow circles in the chart).



Notably, the yield curve is only now entering those mid-to-late 90's levels and has a ways to go before hitting zero. This could coincide with the final push of the current economic cycle--a period of time when stocks continue higher, jobs are plentiful, global central banks are tightening monetary policy, and longer-term rates aren't so high (yet) as to cripple consumers.

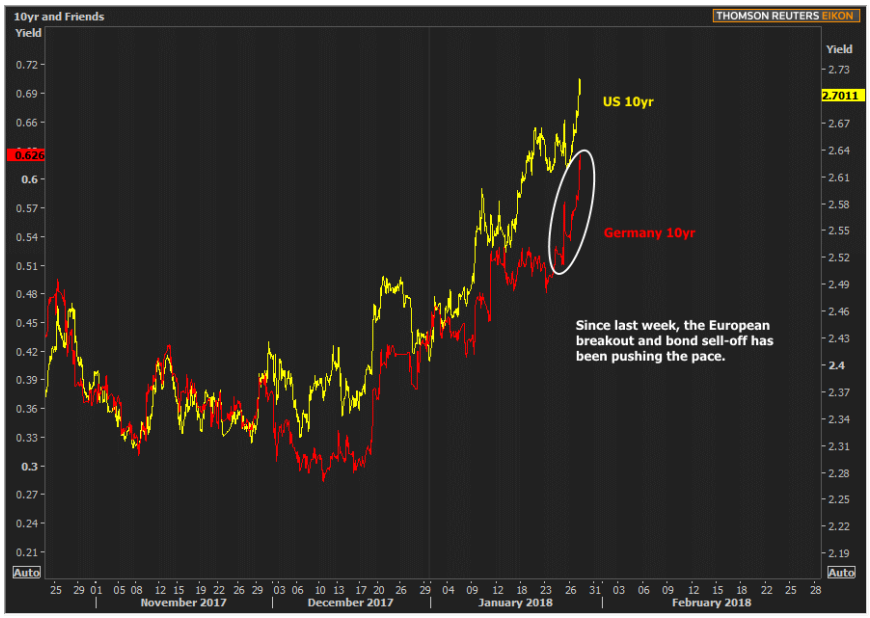
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To be very sure and very clear, however, consumers in this economy **have a limit** as to how high rates can go before we see clear effects flow through to economic data. That process could take 6-18 months, give or take. Additionally, bond market participants know everything I just wrote. They're on guard for the next shift in the cycle in the longer term. That's one of the reasons 10yr yields are only approaching 3% instead of 4%.

In the shorter-term, traders are **on guard against central bank shifts**. This has been a hotter and hotter topic over the past few weeks with speculation that both Japan and Europe are increasingly interested in tightening policy (news over the weekend fanned these flames). This can be seen in the sharper recent move in German Bunds compared to US 10s.



Traders are **also worried** the Fed will join the tightening parade this Wednesday even if only via a slightly more hawkish policy statement. All of the above contributes to a **breakdown of technical ceilings** in rates (which, in turn, has its own negative snowball effect on bonds). Each recent consolidation has given way to another breakout.



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As the previous chart suggests, this pace of weakness **can't go on forever**. While that's obvious and bit vague, the specific implication is that the extent to which the technicals are oversold increasingly suggests a bounce. The higher yields go without bouncing, the bigger the bounce back is likely to be. In any event, the longer-term technical levels from 2013/2014 are prime territory for a supportive ceiling to take shape.



While we'd hope to see nothing more than 2.75%, there's **no way to know** if that will be the case. There's also no way to know if this likely ceiling bounce will result in a short-lived rally, or something that actually provides some breathing room for lenders and borrowers.

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Responsive service, experienced expertise

I've dedicated my 26 year mortgage career to client education, superior service, and honest answers. The lending landscape has changed dramatically the past few years, and continues to do so. My job is to ensure client partners' loans close quickly, without surprises, and I take that responsibility very seriously. Referrals are a responsibility I appreciate; they're a measure of trust, and that trust must be earned every day, on every referral.

Ted Rood

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