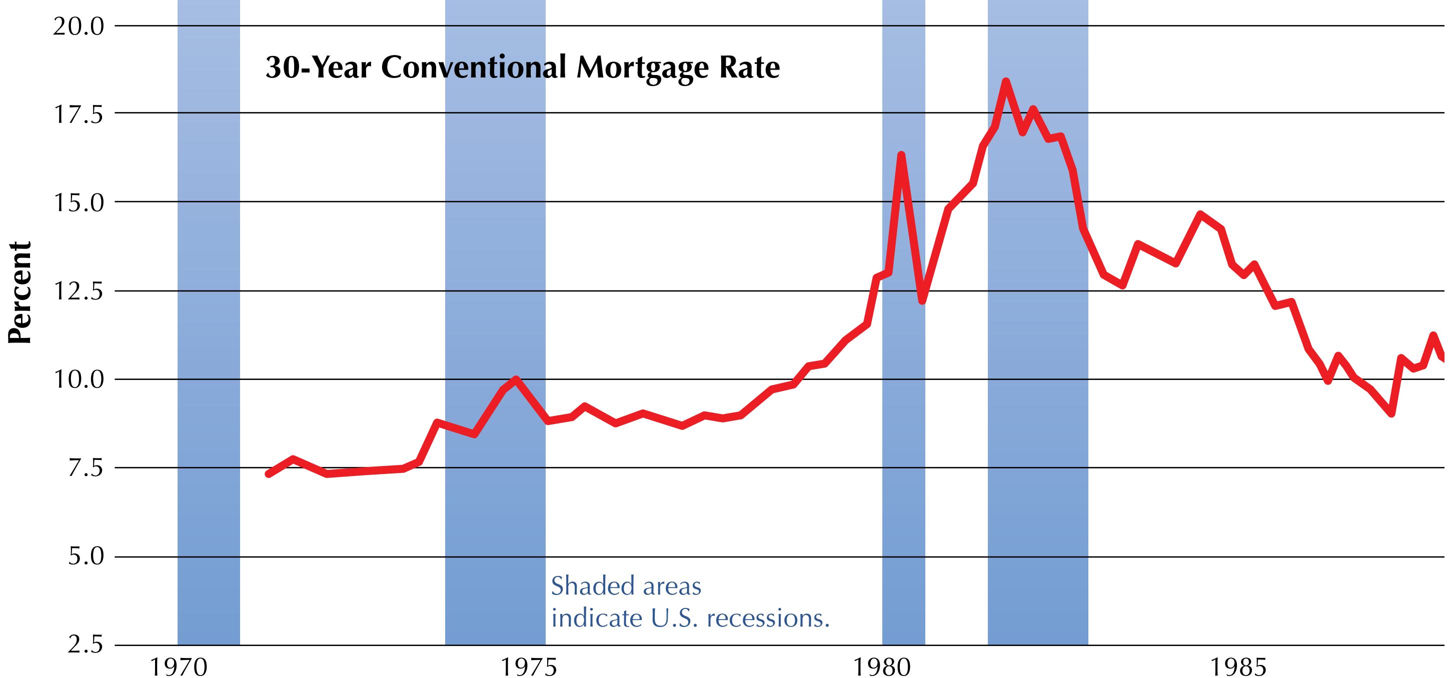
A Reprint from *Tierra Grande*

Rate Expectations

By Mark G. Dotzour

Mortgage rates have been at historic lows during much of 2009. Economic trends and Federal Reserve actions have combined to allow homebuyers across America to purchase homes with a 30-year mortgage below 5 percent.



The history of interest rates for conventional 30-year mortgages in the United States is shown in the graphic. A period of increasing inflation during the 1970s ultimately led to the spike in mortgage rates in 1981 and 1982. At the peak of inflation in October 1981, the 30-year mortgage rate sat at 18.45 percent.

Rates declined precipitously throughout the 1980s, landing at 9.74 percent in December 1989. Mortgage rates are currently at their lowest in the past 40 years.

During the 1990s, a period marked by restrained inflation, rates oscillated between 10.5 percent and 6.7 percent. As the 21st century began, rates hit 8.2 percent, then dropped to a cyclical low of 5.23 percent in June 2003 as the United States tried to rebound from the 2001 recession.

For the next few years, mortgage rates hovered between 5.2 percent and 6.7 percent. The latest decline began in August 2008.

A review of average mortgage rates over the past four decades illustrates just how affordable current rates are.

Average Mortgage Rate (Percent)

1970s	8.90
1980s	12.70
1990s	8.12
2000s	6.33*

*Through September 2009
Source: Real Estate Center at Texas A&M University

Why are mortgage rates so low at the end of 2009? First, the global consensus among bondholders appears to be that inflation will remain low in the United States for an extended period of time. This has caused the ten-year U.S. Treasury rate to fall to between 3.2 and 3.6 percent for much of the second half of 2009.

With extraordinary levels of federal deficit spending, it is unlikely that the low-inflation scenario will be popular when the economy starts to rebound. Expect mortgage rates to rise when signs of improvement appear.

A second factor contributing to the low mortgage rates is the Federal Reserve Bank's unprecedented purchase of nearly all the mortgage-backed securities issued by Fannie Mae and Freddie Mac in 2009. Totaling over $1 trillion for the year, this program has been extended through the end of March 2010.

The Fed has never done this before in its history. They are doing this to stimulate the economy by keeping mortgage rates as low as possible. When the Fed stops buying these securities from Fannie and Freddie, mortgage rates are likely to increase, possibly quite abruptly.

How far will rates go up when the Fed terminates its buying program? That question is difficult to answer precisely, because this action is unprecedented. But many experts think that rates could move up one-half to 1 percent.

The combination of extraordinarily low mortgage rates and current price levels are making homes extremely affordable to American families. In fact, national and Texas housing affordability indices indicate that homes are more affordable than ever. But this will not last. When the economy recovers and the Fed stops purchasing mortgages, rates will rise.

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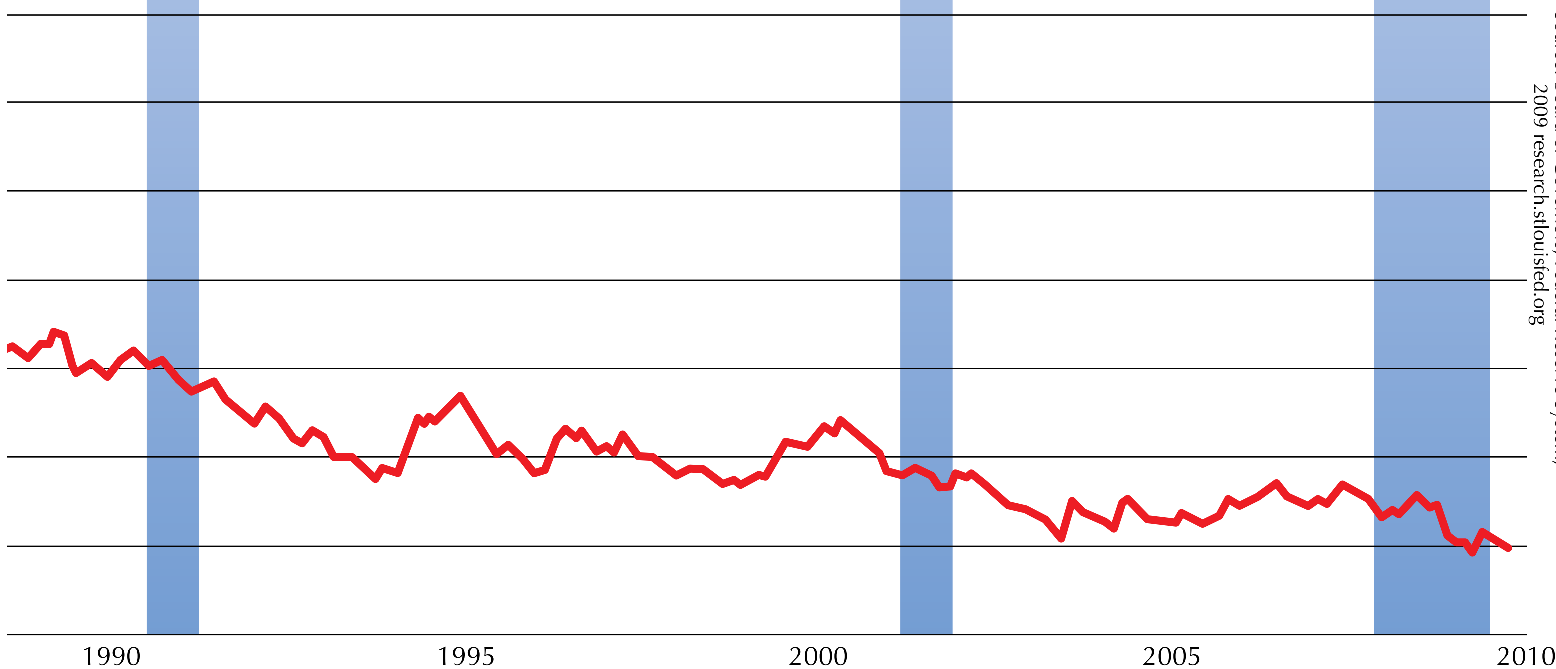
THE TAKEAWAY

Mortgage rates are lower than they have been in 40 years, thanks to the Fed's purchase of mortgage-backed securities and a global consensus that U.S. inflation will remain low. Once the economy begins to recover, the Fed will stop purchasing mortgages and mortgage rates will increase.



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Tierra Grande (ISSN 1070-0234) is published quarterly by the Real Estate Center at Texas A&M University, College Station, Texas 77843-2115. Subscriptions are free to Texas real estate licensees. Other subscribers, $20 per year. Views expressed are those of the authors and do not imply endorsement by the Real Estate Center, Mays Business School or Texas A&M University. The Texas A&M University System serves people of all ages, regardless of socioeconomic level, race, color, sex, religion, disability or national origin. Photography/Illustrations: Robert Beals II, p. 1.