MuhlenkampMethods
For the Intelligent Investor
Answers to questions you may not even know you have.

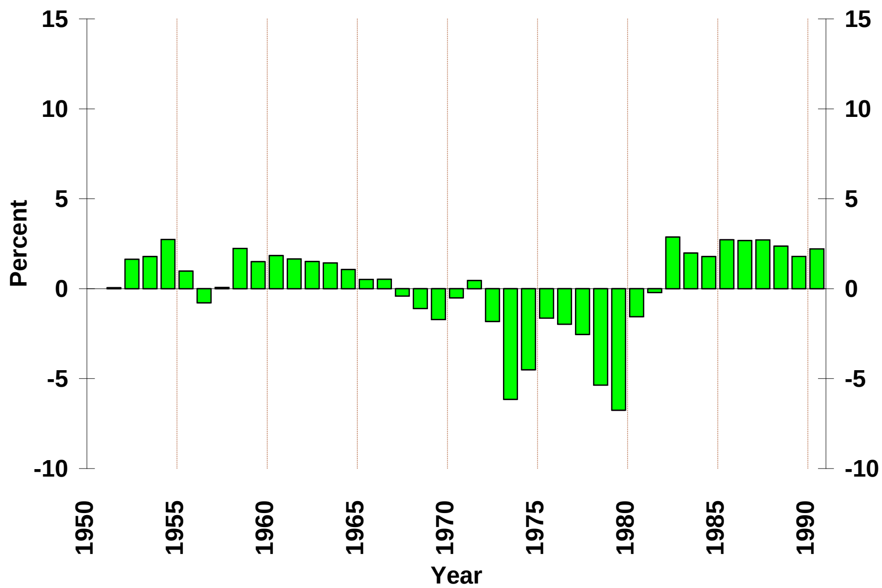
Why Interest Rates Won't "Go Back Up" Any Time Soon

This essay was originally published in Muhlenkamp Memorandum *Issue 20, October 1991. In 1991, whether or not interest rates would "go back up" was a hot topic in economic and investing circles. In June of that year, Ron went to his M.I.T. reunion. He spent half an hour debating interest rates with an old classmate who has a Ph.D. in economics and is the chief economist at a major investment firm. His classmate was certain that interest rates were going to "go back up" because of the federal budget deficit. Upon returning from the reunion, Ron wrote this essay to explain why the shift in the public from "Trade up on the equity" to "Prepay the mortgage" would drive rates down.*

In our first newsletter dated July 1987, we published an essay entitled "Wake Up, America—Houses Don't Make You Money!" In that essay we demonstrated that the long period—1968 to 1980—of house price inflation exceeding after-tax mortgage rates ended dramatically in 1981. Figure 5.8 is an updated version of the bar chart that we used to present this information.

Muhlenkamp & Company, Inc.
Intelligent Investment Management
5000 Stonewood Drive, Suite 300 • Wexford, PA 15090 • (877) 935-5520 • www.muhlenkamp.com

Figure 5.8 Real After-Tax Mortgage Rate, 1952-91



Our essay of 1987 and others like it had no impact. The public wasn't ready. Homebuyers continued to hold attitudes and exhibit behavior that made sense only in the 1968–80 period. Houses continued to be viewed as a "good investment." The limit on size was not family need in any real sense, but the amount that could be financed. Conventional wisdom continued to favor "trading up on the equity" in the belief that an even bigger house (mortgage) was an even better investment. Yet the chart makes it apparent that the game had changed in 1981. Since that time, after-tax mortgage rates have been well above inflation, making a big mortgage a big financial burden. But as long as people believed that house prices in their local area were outpacing inflation, our warning fell on deaf ears.

A Rude Awakening

Recession and the decline in house prices in many parts of the country are now rudely awakening the American public. People who two years ago fully expected to continue "trading up" are now prepaying their mortgage. If there wasn't nearly a decade of financial pressure (see Figure 5.8) at work here, we could dismiss this trend as an emotional shift, subject to short-term reversal. But with this background, we must view it as a delayed realization, which will last at least as long as fundamental pressures remain. In a recent month, 20% of those refinancing their mortgages went to 15- to 20-year fixed rate contracts, which says to us that homeowners are making long-term commitments to "prepay their mortgage" (relative to the standard 30-year contract) in ways not easily reversed. We therefore conclude that the American public is reversing its 25-year mindset. Instead of "trade up on the equity," the new rallying cry of homeowners is "prepay the mortgage." Please reread this paragraph three times; it's that important!

But the second part of the new reality has not yet sunk in. Despite a 10-year decline in interest rates, the mortgage-borrowing public, fearing that rates will "go back up," is still insisting on fixed-rate mortgages. Any fixed rate below 10% is being "locked up" in the belief that it's a temporarily low rate. Meanwhile, the borrower's retired parents are *hoping* that rates will go back up. Banks and savings and loans are telling us that despite the big drop in short-term CD rates (to the current 5% level), many retirees are shortening maturities to 30 or 90 days until rates "go back up." Due to the broad attitudinal changes that we've outlined above, we believe these people will be disappointed.

Contrary to popular opinion, bankers and other financial intermediaries don't care about the level of interest rates. They work on a 2% or 3% spread. The savers of the world (our parents) will receive 2% or 3% less on their deposits than we, the borrowers, are willing to pay. As long as borrowers were willing to pay high rates (because they expected to make money on the asset) they were not active in negotiating lower rates. In the last year, this expectation has reversed. Borrowers are no longer willing to pay 10% or 11%, so lenders (savers) will no longer receive 8%.

But that doesn't stop them from looking for it! Some walk into brokerage offices and buy anything that promises 8%. Today the demand for mortgage participation is so great that yields have been driven down to Treasury levels, even though the mortgages are subject to prepayment at the option of the borrower. People who buy Fannie Mae or Ginnie Mae certificates hoping for an 8% long-term return are going to be disappointed because, as we noted above, mortgage prepayments are increasing. These same people will be back in the marketplace two or three years from now looking for 8% again, and it will not be available.

Other people make basically the same mistake by buying current-coupon corporate and municipal bonds or preferreds. As interest rates fall these instruments will be called or redeemed at the earliest profitable opportunity. An October 11, 1991, *The Wall Street Journal* headline reported that the U.S. Treasury is purchasing some bonds for early retirement, a move it said "will shock many investors." Folks, all borrowers call or redeem their paper for the same reason you or I refinance our mortgage: lower interest costs. The ability to recognize and (more importantly) make your portfolio reflect this fact comes from asking simple questions: Who is on the other side of the piece of paper? What will he or she do? It takes some thought and effort sometimes to get the answer, but it's worth it.

Here is our final comment: we know what the baby boomers are doing; they are paying down their mortgages, but we don't know what the retirees are going to do. In our 1989 essay "The Inflation Time Bomb," we warned that "incomes" were likely to drop from 8% to 5% or lower. The facts have now verified this, but the realization has not yet sunk in for most retirees. Most still live by the maxim: "spend the income—don't touch the principal." In the inflationary cycle of the past 20 years, this maxim has become a trap. Now becoming aware of the trap they are in, retirees' actions so far have merely been stopgap, searching for 8% short-term fixed income returns in a 5% world, with little attention paid to callability. Retirees are faced with the choice of investing in long-term assets, which carry price risk, or accepting a 40% cut (maybe more soon) in their "incomes."

As is often the case in investing, those who saw the pitfalls early have more and better options available for avoiding them. Those options are rapidly diminishing. You do not have to predict economic climate changes, but you must recognize them when they occur.

2007 Update

"Normally," T-Bills are priced to yield about 1% over inflation.

"Normally," 30-year T-Bonds are priced to yield 2½%-3% over inflation.

"Normally," 30-year mortgages are priced to yield about 1% over 30-year T-Bonds.

"Normally," adjustable rate mortgages (ARMs) are priced to yield 2½%-3% over T-Bills.

During the period 1998-2004, nominal interest rates on 30-year mortgages fell from 8% to 6%; (see Figure 1.4.) So the cost of borrowing for a mortgage came down dramatically. And, during the 2001-4 period, T-Bill yields were unusually low at a nominal 1% (and a Real, After-Tax Rate that was negative; see Figures 2.1 and 2.3.) Given the above-listed spreads, ARMs were available at about 4% (and various "teaser" rates were even lower). So if you refinanced your 8% fixed-rate mortgage of 1998 into an ARM in 2003, you could cut your rate in half.

Many people buy houses based on the monthly payment required, so they were able to bid up the price over this period. The game ended in 2005-6.

As the Fed raised short-term interest rates to levels a bit above historic real rates, ARM rates rose above 30-year fixed rates. As a consequence, people are now refinancing their adjustable rate mortgages into fixed-rate mortgages. The remaining question is to what extent the rise in mortgage rates will exceed the capability of some people to make the payments. As I write this in March of 2007, the focus is on sub-prime mortgages, which are simply mortgages written to people with limited (sub-prime) assets or income, who may not be able to meet the increased rate.

Editor's Note

It's been 16 years since this essay was written. Have interest rates gone back up to the levels of 1990? Figures 1.4 and 2.1 clearly show that they have not.