

the Mortgage Commentary

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Wild cards can impact mortgage rates

Inflation is the ultimate driver of mortgage rates. Inflation is to mortgage rates as Kryptonite is to Superman's powers.

Inflation is harmful to mortgage rates because those rates are determined by investor demand for Mortgage Backed Securities. Investors in MBS need a return that accounts for inflation. The higher the inflation rate, the higher mortgage rates must be to compensate.

Barry Habib, of Mortgage Market Guide uses this analogy:

"Think of inflation as the ocean and interest rates as a boat. As inflation (or the ocean's tide) rises, interest rates (or the boat floating atop the ocean) have to rise as well. In other words, interest rates (or boats) must always be higher than inflation (or the ocean) to compensate investors."

Remember that analogy anytime you wonder which way mortgage rates are likely to move.

A declining or sluggish economy does not produce inflation. Thus as the economy declined, so did interest rates.

But an improving economy can spark inflation as costs of materials, production and labor rise to meet demand. So, if and when the economy shows signs of recovery, it follows that mortgage rates will rise.

The one time Secretary of Defense Donald Rumsfeld might categorize inflation as one of the "known known's". Because everyone knows that inflation, or even the slightest whiff of inflation can cause rates to go up.

There are some other "lesser known's", but they all trace back to the absence, the presence, or the possibility of inflation: canaries in the mine, if you will.

Simply put, anything that is good for the economy is potentially bad for mortgage

rates and vice versa.

In addition to the factors known to influence rates are wild cards which can trump, or override (for a time) other factors. And we see some wild cards right now.

One wild card is the massive political unrest abroad. The uncertainty created by this unrest makes stock investors nervous. And nervous stock investors tend to pull funds from the stock market and place it in the safe haven of bonds. Demand (and price) for bonds rises and this drives down rates.

At the moment, this wild card has trumped gathering evidence that the economy is slowly recovering. It has also trumped fear of inflation because of our ever growing deficit. Were it not for this wild card, rates would be higher than they are today.

As soon as the hoped for stabilization returns to countries like Libya, Tunisia, and Egypt, funds will tend to flow back out of the bond market into stocks. Bond prices will fall and rates will rise.

Other wild cards likely to cause rates to rise are courtesy of our government. Here are some of those.

The administration has signaled its intent to wind down Fannie Mae and Freddie Mac, thus removing roughly 60% of the mortgage market.

It also wants to reduce FHA's role from 30% of the market to 10%. This may be gradual, but will put pressure on rates as private investors cover the hole left by Fannie, Freddie, and FHA.

Yet another wild card that could cause rates to rise is a round of new, confusing, and costly regulations that are being placed on the mortgage industry.

It is not possible to quantify the extent to which rates will rise or when, but it is a near certainty that they will rise.

The IRS will (also) modify procedures that will make it easier for taxpayers to obtain lien withdrawals. Liens will now be withdrawn once full payment is made if the taxpayer requests it.

Is it time to take up ARMS?

Mortgage rates are now above their historic lows of last fall.

While they were at these historic lows, it made great sense for borrowers to lock in 30 year fixed rate loans for two reasons. One, they were at historic lows and two, the gap between fixed rates and ARMS was very narrow.

So why take an ARM loan at all, even if the intention was to keep the loan for a short period of time? The small difference was not enough to take the small risk.

But now, the gap between fixed and ARM loans has widened and for many borrowers, the decision is not as easy as it was. There's greater incentive to take the lower rate of an ARM.

Everyone can easily figure the "savings" of an ARM. They simply subtract one monthly payment from the other. But there's more to be considered. We won't go into all of the figures here, hopefully just enough to give you the picture.

A 5/1 ARM loan of \$1,000,000 at 4.25% has payments of \$5,067 per month.

A fixed rate payment at 6% is \$5,995.

That's a savings of \$55,720 in five years compared to a fixed rate of 6%.

At the end of five years, the balance for the fixed rate at 6% is \$929,200.

But if the borrower takes the 5/1 ARM at 4.25% and makes payments as if the interest rate was 6%, the balance at the end of five years would be will be \$846,400.

So the potential savings — ARM vs fixed — can be more than \$55,720. It can be the difference between \$929,200 and \$846,400, or \$82,800.

It may not be the time to take up ARMS, but it certainly is time to consider them, particularly if your horizon time is short.

IRS tax lien relief

There is rarely good news around Federal Tax liens. But a new policy of the IRS might be good news for those unfortunate enough to have had a tax lien filed.

In the past, once a tax lien is filed and recorded, it stays on your credit report for seven years. The initial impact on credit score is huge, as you might expect: probably a hit of 100 points or more.

With the passage of each ensuing year, the impact is less, but the lien itself remains for seven years even if paid in full.

The IRS is changing that. Quoting from the IRS website IR-2011-20, Feb 24, 2011:

"The IRS will (also) modify procedures that will make it easier for taxpayers to obtain lien withdrawals. Liens will now be withdrawn once full payment is made if the taxpayer requests it. The IRS has determined that this approach is in the best interests of the government. In order to speed the withdrawal process, the IRS will also streamline its internal procedures to allow collection personnel to withdraw the liens."

We tried to find out what the procedure is for making the request for withdrawal of tax liens without success. We should know more in time for next month's Commentary.

The new policy will, of course, incentivize prompt payment of tax liens, since their withdrawal and disappearance from credit reports will enable folks to get on with their (credit) lives sooner.

At the same time, one has to wonder. Was it the IRS that required the credit agencies to keep federal tax liens on reports for seven years? Or was it the agencies themselves? If it was the agencies, this begs the question: can the IRS dictate reporting rules to credit agencies?

Guess they can.

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