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Freddie Mac's benchmark 30-year, fixed-rate mortgage is nearing 7%. DAVID ZALUBOWSKI/ AP

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A 'Hidden Force' Can Bring Mortgage Rates Down

Mortgage rates have been moving against home buyers in recent weeks. But there is a sliver of hope on the horizon.

Freddie Mac's benchmark national average 30-year, fixed-rate mortgage is nearing 7% once again, a far cry from when it looked like it was heading below 6% back in the early fall.

Several things have driven rates back up, including rising longterm Treasury yields, fears about accelerating inflation and a shrinking number of expected Federal Reserve rate cuts.

And it is unclear if any of those big factors will change in the near future, especially with swirling uncertainty about policies such as tariffs.

Yet there are reasons to be somewhat, cautiously, optimistic. One thing that could help fuel a move lower in rates—even without those big macroeconomic variables changing—would be a shift in what some have called the "hidden force" behind mortgage rates: The unusually wide gap between mortgage rates and Treasury yields.

By one key measure, the gap, or "spread," between current coupon benchmark mortgage bonds and the yield of relevant Treasurys is between 1.3 and 1.4 percentage points, according to data compiled by mortgage strategists at Bank of America.

That gap has been unusually big for a couple of years now, well above the sub-1-point gap seen back in 2019. Drivers include volatility, a lack of demand for mortgage bonds from banks and the end of Federal Reserve mortgage bond buying in 2022.

But finally, this year, there is a view that conditions may be ripe for the gap to tighten back toward roughly 1 percentage point, which in turn could lower the mortgage rates on offer to borrowers.

"We see 2025 as the year that mortgages will find an equilibrium somewhat tighter than current levels," mortgage strategists at FHN Financial wrote in a recent note, referring to bond spreads.

Markets are pricing in only one to two more rate cuts this year, according to the CME FedWatch tool, meaning these moves likely wouldn't do much to change mortgage rates—as was the case with prior, anticipated cuts.

However, spreads might tighten once the Fed ends its cutting cycle, as volatility in the rate market subsides and investors feel more comfortable placing longer-duration yield bets. Volatility is typically a driver of the widening gap.

"One overarching theme is that when the Fed steps out, volatility should subside, and bring more investors into the market for mortgage bonds," says Jeana Curro, head of agency mortgage-backed securities strategy at Bank of America.

That demand step-up may come from a couple sources, including mutual funds and exchange-traded funds, a market that features several funds focused on mortgage bonds.

It might also come from U.S. banks. Lower benchmark interest rates may induce banks to take on more duration, or invest in more long-term assets, to earn a higher yield. The potential end of the Federal Reserve's balance-sheet shrinking also could boost bank deposits, in turn fueling additional bond buying as banks look for somewhere to park funds. A looser capital regulatory regime could lead to more buying, too.

Whether the Fed actually makes good on anticipated cuts in 2025 could be a swing factor for bank purchases of mortgage bonds.

With at least two more cuts, and with an interest-rate curve that steepens to reflect them, "we think bank demand will continue to accelerate," says FHN Financial mortgage strategist Walt Schmidt. "However, anything less than that will likely dampen bank demand, which would produce a longerterm holding pattern for spreads."

So nothing is set in stone. But it is possible that buying or refinancing a home might just be marginally cheaper this year.

—*Telis Demos*

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