The Importance of Low Long-Term Rates To The US Economy

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The Chart below illustrates the price performance of the US Bloomberg Mortgage Bond Index (White line) and the US existing median home price (green line).

Investor support for US Mortgage bonds has been extremely healthy over the last four years by virtue of the Federal Reserve's Asset Purchase Program (The Fed is purchasing $40billion a month of US Mortgage Backed Securities). The explicit guarantee of the Fed combined with a low rate environment, made reaching for yield in this sector attractive for many investors. This has belatedly found its way into the price of existing homes, with the median price increasing approximately 20% from the beginning of January to the end of May.

For US Mortgage bond investors, the announcement around a reduction and eventual end of asset purchases was a double whammy, at once removing the explicit put option for MBS and increasing the comparative long-term treasury rate simultaneously.

The demand and increased issuance of mortgage backed securities (at low rates) has been crucial in driving resurgence in US home prices. The US housing recovery has in turn been a key driver in increased consumption and investment. With US Mortgage rates rising sharply, maintaining the momentum will be difficult at best.

Source: Bloomberg

This is one of a number of examples that highlights the role low long-term rates and asset purchases have played in the US economy up until this point.

In summary it is difficult to see how US bonds could sell off meaningfully from current levels given the potential effect on the real economy and asset prices more broadly. This would also explain the strong response by various Fed members, in an attempt to re-align market expectations.

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