Recent Spike in Rates and Actions to Take

How higher rates may impact mortgage origination and spread and what to do now

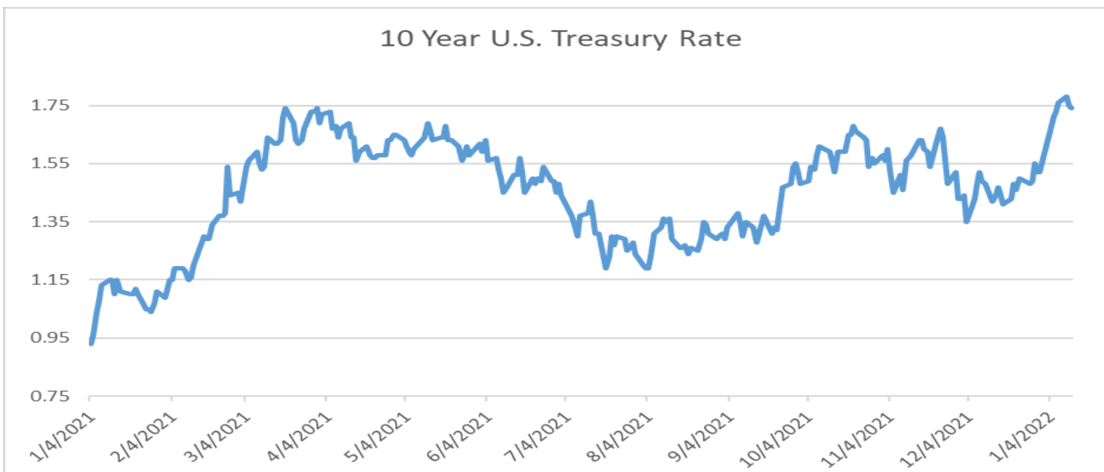
"Several Factors Driving Long Term Rates Higher"

Recent Spike in U.S. Bond Yields:

In our most recent Economic Outlook, Charley McQueen discussed the recent rise in long-term bond yields and the potential for Federal Reserve rate hikes in 2022. In this supplemental report, we examine the reasons for higher long-term rates and what they may mean for financial institutions.

Long-Term Bond Yields Up Sharply:

At this time last year, 10 year US Treasury yields were less than 1.00%. After rising early in the year to nearly 1.75%, rates fell in late summer and were less than 1.5% for many months. Starting in late 2021, 10-year rates rose sharply and are above the 2021 high as of mid-January 2022.



What's Driving the Recent Spike in Long-Term Rates?

We believe there are several factors driving long term rates higher:

- Although cases are sharply higher, medical reports have indicated that the Omicron variant of COVID-19 is less severe than other variants. Vaccines and booster shots have proven effective at diminishing severe illness. This has given markets some degree of relief because the fear of global economic slowdown has subsided.
- The U.S. unemployment rate fell below 4.00%. The consensus expectation was that 422,000 jobs would be created in December and the actual number fell far short, at 199,000 new jobs. This was initially a disappointment because hiring in the month was not very impressive. However, the overall unemployment rate fell to just 3.9%, which is well below the 4.2% rate in November.
- Inflation hit the highest level in nearly 40 years. The FOMC will raise interest rates to slow the inflation rate.
- The Federal Reserve has also reduced monthly bond purchases as it unwinds its quantitative easing program.

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What Does This Mean for Financial Institutions?

The impact of higher long-term yields can be favorable and unfavorable, simultaneously!

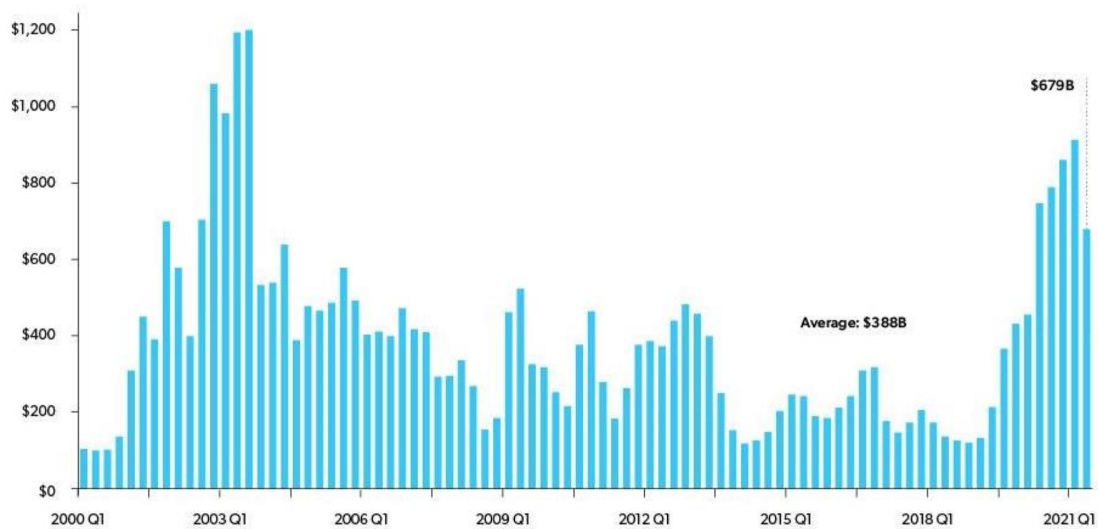
Slower Mortgage Lending:

The past few years have represented an extraordinary opportunity for mortgage holders to refinance and take advantage of substantially lower rates. Many of our clients have capitalized on this opportunity by ramping up mortgage originations and earning substantial fee and gain-on-sale income. With higher long term rates, the opportunity will likely slow down. However, as reported by Freddie Mac, the refinance boom in the past 2 years was still below the pace of the refinance boom in 2003. While activity may slow, there are still millions of mortgage holders who can still refinance and save plenty.

"Millions of Mortgage Holders Can Still Refinance"

EXHIBIT 1

U.S. single-family mortgage refinance originations (2020 U.S. dollars, billions)



Sources: Freddie Mac Economic and Housing Research Total Market Estimates, Originations deflated by U.S. Bureau of Labor Statistics CPI-U All Items.

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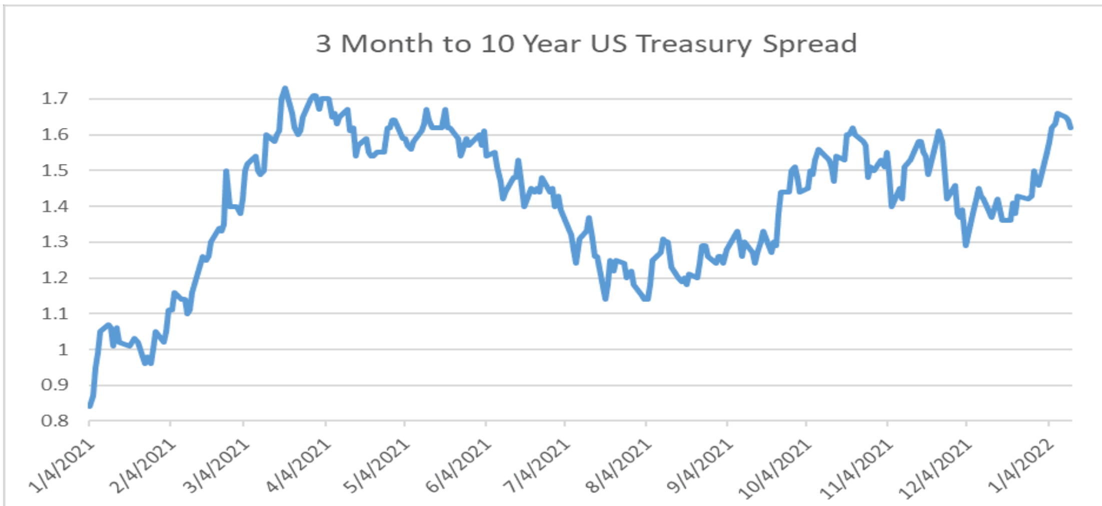
More Favorable Yield Curve:

Financial institutions generally make more money when the yield curve is steep. When long-term rates rise and short-term rates remain low, some loan rates will head higher over time and long-term investment yields increase immediately. The graph below displays the spread relationship between short-term rates and long-term rates. Clearly, the recent spike in long-term rates has created a more favorable margin for many of our clients.



"…More Favorable Margin"

Action Items:

We suggest the following:

- Remain fully invested: Overnight funds accounts are paying less than 0.10%. Even short-term investments can easily outperform cash yields by as much as 10 times!
- Continue Mortgage Underwriting: There is plenty of opportunity for fee income and gain on the sale. The low-hanging fruit may have been picked over, but millions of borrowers can still benefit from lower rates. In January 2022, we analyzed a pool of mortgages that our client previously sold to Freddie Mac and found a very large refinance opportunity. Over 2,000 loans with an unpaid principal of $400 million were good candidates for refinancing.
- EBPA and CDA funds are generally invested in longer-term securities and these yields look more attractive lately. Talk to us about specifics. We have many success stories that we'd love to share with you.