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Odds of Fed Rate Cut Increase

With worries about credit quality and availability mounting, futures markets are once again pricing in a rate cut by the Federal Reserve by the end of the year, several news sources report. The federal funds futures market at the Chicago Board of Trade now sees a 96% chance of a rate cut by Dec. 31, up from about 47%. That's almost 100 percent, which means it is a virtual certainty, according to the futures markets.

The odds of a rate cut at the Oct. 31 meeting rose from 18% to about 40%. The Fed has kept its overnight lending rate target at 5.25% for more than a year. Officially, the Fed is still "biased" toward raising rates, with officials judging that the risks of higher inflation outweigh the risks of a slower economy.

Fed Chairman Bernanke started the rate downturn last week at his semi-annual Humphry-Hawkins congressional testimony on the state of our economy, when he downgraded predicted GDP growth rate to 2.25 – 2.75 percent from 2.5 – 3 percent. Why? Bernanke stated that the real estate downturn could be deeper and last longer than earlier thought. This raised fears that subprime worries could spread into other credit markets, making credit for prime borrowers harder to obtain as well.

"The pace of home sales seems likely to remain sluggish for a time, partly as a result of some tightening in lending standards and the recent increase in mortgage interest rates," said Bernanke in his testimony. "However, even if demand stabilizes as we expect, the pace of construction will probably fall somewhat further as builders work down stocks of unsold new homes. Thus, declines in residential construction will likely continue to weigh on economic growth over coming quarters, although the magnitude of the drag on growth should diminish over time."

But there is good news in the bad news. Mortgage rates are declining in tandem with long-term Treasury bond rates, and this could cause real estate to turnaround sooner. The10-year benchmark T Bond yield that pegs most fixed rate mortgages has fallen to 4.78 percent, after remaining above 5 percent for several weeks.

Recent data showed the 30-year fixed-rate mortgage averaging 6.69% for July 20-26, down from the previous week's 6.73% average. The mortgage averaged 6.72% a year ago. The 15-year averaged 6.37%, down slightly from last week's 6.38% but above 6.34% a year ago.

The softening rates came after further evidence of sluggish housing demand, Freddie Mac vice president and chief economist, Frank Nothaft, said Thursday.

"For example, building permits fell last month to the slowest pace in a decade, and more recent data on June sales of existing home showed a fourth consecutive monthly decline," he said in a news release.

Existing-homes
June sales dropped 3.8 percent to the lowest pace in 5 years. Inventories also declined, as some sellers are taking their homes off the market, according to the NAR. The median price rose slightly, but Moody's economist Mark Zandi attributed it to the subprime "debacle", as fewer qualified lower-income buyers are skewing the median price higher.

New-homes
June sales dropped 6.6 percent. The median price was down 2.2 percent and new-home inventories rose to a 7.8-month supply. More noteworthy was that it now takes 6 months to sell a unit upon completion, whereas average time was 4.3 months last year.

In other news, Wells Fargo Home Mortgage, the second-largest holder of subprime loans, said this week it will close its nonprime wholesale lending business that processes and funds subprime loans for third-party mortgage brokers. In 2006, the business represented 1.6% of Wells Fargo's total residential mortgage loan volume of $397.6 billion.

The Federal Reserve should contemplate dropping short-term rates this year. Fed Governors may begin to drop hints of a change in policy at the August FOMC meeting. Their actions since June 2004 have pushed the real, underlying interest on ARMs above 8 percent to payment amounts that many middle-income, as well as lower-income, homeowners can no longer bear in many regions with today's elevated loan amounts.

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