# ALL BUSINESS: Bond-market rout lifts mortgage cost

## ALL BUSINESS: Bond-market rout boosts mortgage rates, undermining economic prospects

- Rachel Beck, AP Business Writer
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NEW YORK (AP) -- The Federal Reserve announced a $1.2 trillion plan three months ago designed to push down mortgage rates and breathe life into the housing market.

But this and other big government spending programs are turning out to have the opposite effect. Rates for mortgages and U.S. Treasury debt are now marching higher as nervous bond investors fret about a resurgence of inflation.

That's the Catch-22 threatening to make an awful housing market potentially worse and keep the economy stuck in a funk. Kick-starting the economy requires higher spending, but rising rates mean fewer Americans will be able to refinance their home loans. And some potential buyers will be shut out of the market by higher monthly payments they won't be able to afford.

To understand how this is all connected, you have to think like a bond trader. Inflation is their enemy because it means the purchasing power of the dollars they receive when bonds eventually are paid off will be diminished. The only question is by how much.

Yields on 10-year Treasury notes, a benchmark for home mortgages and other consumers loans, jumped from 2.5 percent in March around the time of the Fed announcement to as high as 3.7 percent in recent days as signs that efforts to stabilize the financial system and economy were starting to pay off. And 30-year mortgage rates jumped more than a quarter-point this week to 5.29 percent, the highest level since December, Freddie Mac reported.

"If the meltdown continues in the bond market, then mortgage yields will soon be at levels that choke off refinancing activity," said economist Ed Yardeni, who runs his own investment firm. "Even worse, they could abort any necessary recovery in home sales and prices."

Yardeni coined the term "bond vigilantes" in 1983 to describe how traders took matters into their own hands when they felt the Fed wasn't doing enough to fight inflation, which was running at an annual rate of more than 3 percent at that time.

So what has set off the vigilantes this spring, at a time when the consumer price index is down at an annual rate of 0.7 percent?

One explanation is that bond investors anticipate a greater supply of government debt being sold to fund federal spending. Investors are also increasingly fearful that the trillions of dollars the government will need to borrow in the coming years to finance the various stimulus programs will lead to a new bout of inflation.

The White House estimates that the government will rack up an unprecedented $1.8 trillion budget deficit this year -- more than four times last year's all-time high.

"The bond market is calling the Federal Reserve out," said Mike Larson, a real estate analyst at Weiss Research Inc. in Jupiter, Fla. "Investors are saying that the Fed can't just print money out of thin air to finance a massive deficit."

Fed Chairman Ben Bernanke acknowledged Wednesday in congressional testimony that large budget deficits could threaten financial stability by eventually eroding investor confidence and endangering the economy's prospects for long-term health.

"Even as we take steps to address the recession and threats to financial stability, maintaining the confidence of the financial markets requires that we, as a nation, begin planning now for the restoration of fiscal balance," Bernanke told the House Budget Committee.

That kind of talk is meant to calm bond investors' nerves. It also shows the quandary faced by Bernanke and other federal officials. They need to hold down interest rates through massive government spending at the same time they have to deal with worries over how that spending could damage the economy over the long term.

After Fed policymakers this spring said they would buy billions of dollars of government debt and more than $1 trillion of mortgage securities, 30-year fixed mortgage rates fell to 4.78 percent in April, the lowest since Freddie Mac started surveying rates in 1971.

Sales of new and existing homes began to trend higher. Mortgage refinancings also jumped, allowing borrowers to lock in lower rates. Fee income from this activity helped lift profits at many battered banks and gave consumers more disposable income to spend, which helped lift their confidence about the economy's prospects. All that was good for the nation's businesses.

But now, surging mortgage rates are threatening to undermine all that. Seventy percent of refinancing activity could be knocked out as rates close in on 5.5 percent, according to Mark Hanson, a managing director at the independent research firm Field Check Group of Menlo Park, Calif.

That's because homeowners wouldn't get much of a benefit if a refinancing only reduces monthly payments a tiny bit while they are stuck paying closing costs that typically run about 2 percent of the loan amount.

Also, many homeowners who wanted to refinance didn't lock in the super-low rates in April when the refi boom took off. "Half the deals in the pipeline are dead," Hanson said. "People were applying to refinance to improve their situation, but now they are seeing it won't be much improved."

All this means that even though mortgage rates are still low by historical standards, many of the trends that seem to be pointing to economic recovery in recent months could be undone fast.

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