

## **MORTGAGE RATES**

Reflection for 2005 and Prediction for 2006

By Jessica Bennet (<http://www.mortgagefit.com>)

In association with

Lance Williams (Financial Consultant)

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## *Index*

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<i>S. No.</i>	<i>Topic</i>	<i>Page No.</i>
1.	<a href="#"><u>Acknowledgement</u></a>	3
2.	<a href="#"><u>About MortgageFit Community</u></a>	4
3.	<a href="#"><u>Mortgage rate - the driving force behind the industry</u></a>	5
4.	<a href="#"><u>Looking back at 2004 – Early signs of rising rates</u></a>	6
5.	<a href="#"><u>1st Quarter 2005: Rates boost up consumer spending and housing sector</u></a>	8
6.	<a href="#"><u>2nd Quarter 2005: Rates dip 14 month low, fosters new housing demand</u></a>	10
7.	<a href="#"><u>3rd Quarter 2005: Rates shoot up amidst hurricane disasters</u></a>	12
8.	<a href="#"><u>4th Quarter 2005: Fed raises rates again, housing market declines</u></a>	14
9.	<a href="#"><u>Transitioning into the New Year – Rates to continue its upward trend</u></a>	17
10.	<a href="#"><u>Glossary</u></a>	19

## *Acknowledgement*

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MortgageFit Community is dedicated to help the common people by providing them with updated information on recent market trends. This also includes the variation in mortgage rates that affect the industry. This e-book has been conceptualized by Sam Palmisan and it aims to provide an overview of the industry rates in 2004, how the rates have turned out in 2005 and where they are heading in the current year.

[Back to Index](#)

## *About MortgageFit Community*

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MortgageFit has the vision of building up a community for the development of the mortgage industry. It aims to create an open platform for borrowers and lenders who can interact with each other in a fair marketplace.

The financial strength of the common people is the key to the growth and development of the mortgage industry. It is their buying power that helps the industry move on to a bright future ahead. [MortgageFit](#) has resolved to come up with innovative ideas using which the Community members can work together with a common purpose – empowering the industry and making it independent.

The industry has come across a lot of frauds and scams and borrowers have suffered at the hands of lenders and mortgage companies indulging in abusive lending practices. Our Community aims to remove all such discrepancies in order to avoid any kind of manipulations and make the industry a better place for the common people. Our Community wishes to empower the common people by helping them with the most appropriate solutions when they are in financial distress.

MortgageFit believes in sharing of ideas and opinions through its [Forums](#) for the benefit of the community. Keeping in mind the interests of the common people, MortgageFit has also built up a [mentor club](#). The mentor club comprises of mortgage mentors who are engaged in helping individuals with ideas and suggestions to build up a better community.

[Back to Index](#)

## *Mortgage Rate – the driving force behind the industry*

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Mortgage industry is one of the biggest industries having an impact on the US economy. The major factor that keeps this industry going is the mortgage rate which depends on the direction of the interest rate. Besides, the supply and demand for mortgages also affect the ups and downs in the rates applied on these home loans.

The US economy is affected by the housing market which in turn depends on the prospect of the mortgage industry. The industry is in turn, influenced by the fluctuation in rates applicable on short term and long term home loans. The short term rates are raised by the Federal Reserve in order to fight inflation and these in turn affect the rates on short term mortgages (ARMs etc). The Fed's initiative also has an affect on long term rates. But these rates are mostly dependant on the yields on the 10 Year Treasury note issued by the US government.

The demand for mortgages is inversely proportional to the prevailing mortgage rate. Rates affect the borrowing costs payable by consumers. Low rates imply that buyers can afford higher home prices and this helps in the growth of the housing market. Such rates make mortgages cheaper, and increases consumer spending which in turn brings about the growth of economy.

[Mortgage rate](#) is regarded as the driving force behind the industry - it determines how the industry would affect the economy. Low mortgage rates can help you get home loans at lower costs, and lure you to go for cash-out refinancing. This helps in increasing your expenditure as a consumer thereby sustaining economic growth when businesses attempt to reduce their investment expenditures. But the economy often shows a decline with the mortgage industry raising the rates on various products thereby lowering the demand. Higher rates result in huge borrowing costs, greater chances of delinquency and reduced consumer spending.

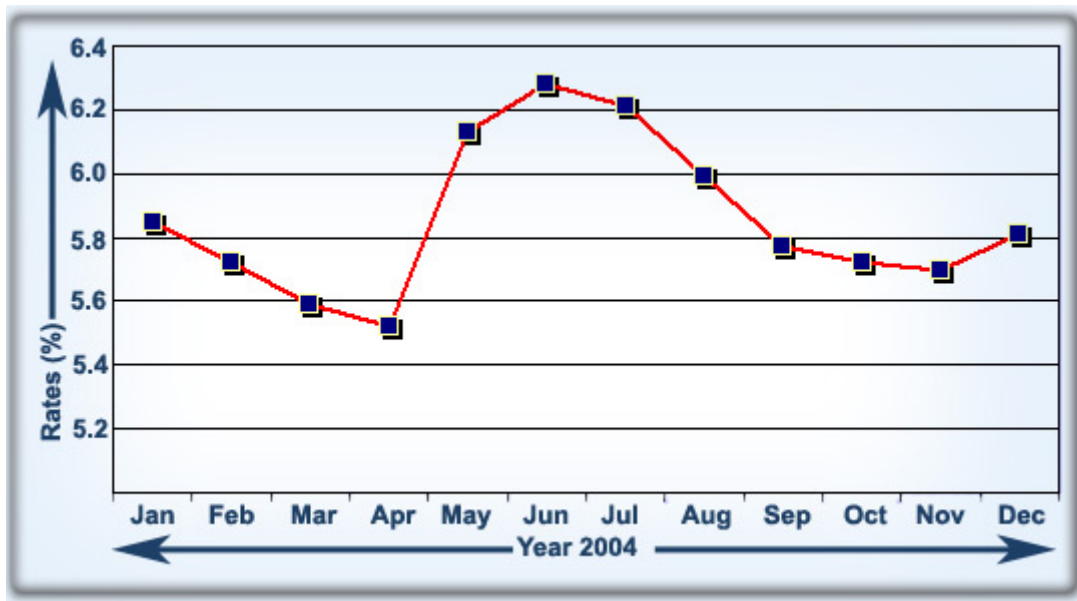
Therefore, it is needless to mention that mortgage rates have a profound influence on the industry. It regulates loan originations for different kinds of mortgages and indicates the direction towards which the industry will move ahead.

[Back to Index](#)

## Looking back at 2004 – Early signs of rising rates

The year 2004 evoked a mixed response from the mortgage industry with interest rates fluctuating from low to high and finally slowing down in the fourth quarter. Rates on 30-year fixed mortgages remained as low as 5.4% and this is what boosted housing affordability in the first quarter. Median income households could now afford a home at a higher sale price in comparison to the national median price. Along with this, the share of refinancing activity registered a decline but at the same time, the share of cash-out refinance went up.

However, mortgage rates moved up from 5.38% in mid-march and crossed 6.0% in late April thereby reducing the [refinance](#) share of loan applications to 40%. With the decline in refinance applications, total equity cashed out in the second quarter came down to \$20 billion, slightly lower than \$23 billion that was recorded in the first quarter. The decline in the share of refinancing continued further till the third quarter when rates on 30 year fixed rate mortgages moved up higher than 6%.



In spite of a slowdown in refinancing activity, cash-out refinance remained a favorable option for conducting home improvements and consolidating debts. However, the cash-out share of new refinancing registered a slowdown when mortgage rates remained below 5.7% for several weeks during the 4<sup>th</sup> quarter. But, the number of applications for refinancing had gone up to 47% due to the reduction in the rates of 30 year fixed rate mortgages.

Unlike the long term rates, the Federal Reserve raised short term rates about 5 times over the last half of 2004 thereby increasing the initial rates on ARMs by 40 basis points throughout the year. The 5/1 hybrid ARMs gained popularity due to an average initial rate of 4.99%, that is 0.82 percentage points above the rate on 1 year ARM and 0.65 percentage points below the rate on 30 year fixed rate mortgage.

### **Conclusion:**

On account of rising mortgage rates, general affordability for housing may have declined in the second and third quarters. But the sales of existing and new homes remained favorable throughout the year. Residential construction throughout the nation jumped up by 10.9% in December – the biggest in 7 years. The Federal Reserve had been gradually raising short-term and long-term rates but on the whole, mortgage rates remained low and continued to fuel the housing market.

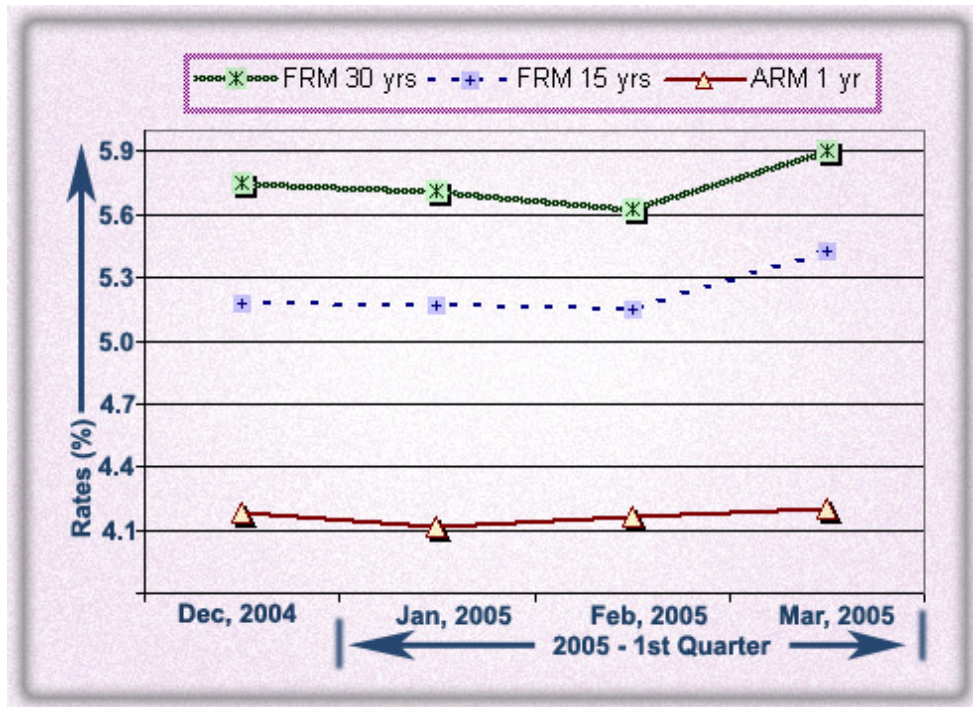
[Back to Index](#)

## 1st Quarter 2005

### Rates boost up consumer spending and housing sector

The US mortgage industry in the year 2005 experienced several hikes in interest rates, especially the short term rates. Such repeated rate hikes affected mortgage loan originations and the housing market. The treasury markets responded well by bringing down the yields on long term interest rates. This led to a decline in the rates applied on benchmark 30 year fixed rate mortgages tied to the Treasury yields to levels not recorded since March 2004.

Mortgage rates for the first quarter remained low thereby favoring the growth of the refinance market and a record in the home sales and single-family starts. On an overall basis, the contract mortgage rates for 30 year mortgages



moved up to 5.76%, 3 basis points higher than that of the previous quarter and 16 basis points higher than the first quarter of 2004. On the other hand, 15 year fixed mortgage rates climbed 5.26%, up from 11 basis points from what prevailed in the 4th quarter of the previous year and up 36 basis points from the first quarter of the same year.

Unlike fixed rate mortgages, adjustable rate mortgages recorded an interest rate of 4.17% in the first quarter, 5 basis points higher than the last quarter of 2004. But even with the rapid growth in short term rates, the ARMs retained one-third share of loans closed over the first two months of this quarter. There was a re-emergence of teaser rates on 1 year ARMs which favored the growth of these home loans. Hybrid mortgages

offering the interest-only payment option helped to keep the initial monthly payments on the ARMs low enough to lure borrowers away from fixed rate mortgages.

However, interest rates on 30 year fixed rate mortgages dipped below 5.7% in the last 2 weeks of January and remained low throughout February. Due to mortgage rates remaining low, there was an increase in the applications for cash-out refinancing with the overall refinancing applications accounting for 45% of the total mortgage originations. Growth in cash-out refinancing boosted consumer spending. Homeowners refinancing their existing loans were able to save \$100 million per month as a result of low interest rates. These savings coupled with a large amount of home equity cash-out proved to be a major factor behind the huge expenditure in home improvements.

Along with the rise in home improvements projects, there was also an increase in housing affordability to 76.6% from 76.2% in the last quarter. On account of low mortgage rates, only 18.8% of family income was used up in making the median mortgage payments and this boosted up the sales of residential properties. Home sales rose 9.4% in February to an annualized 1.23 million units, up from the sales rate of 1.12 million units in the month of January.

### **Conclusion:**

With interest rates remaining at moderate levels, the US mortgage market in the first quarter experienced a substantial growth with increased number of refinance and purchase loan applications. There was also a simultaneous development in the housing market. ARMs especially hybrid ARMs became quite popular in spite of the frequent hikes in short term rates. The teaser or discount rates on these loans helped in raising the volume of the loan originations in case of adjustable rate mortgages. Moreover, rising family income helped to offset higher mortgage rates and home prices in the first quarter thereby boosting the overall home-buying power of moderate income families. Home prices may have been on the rise since the past few years, yet the biggest factor – mortgage payment remained historically low and this is what favored the growth of the mortgage market.

[Back to Index](#)

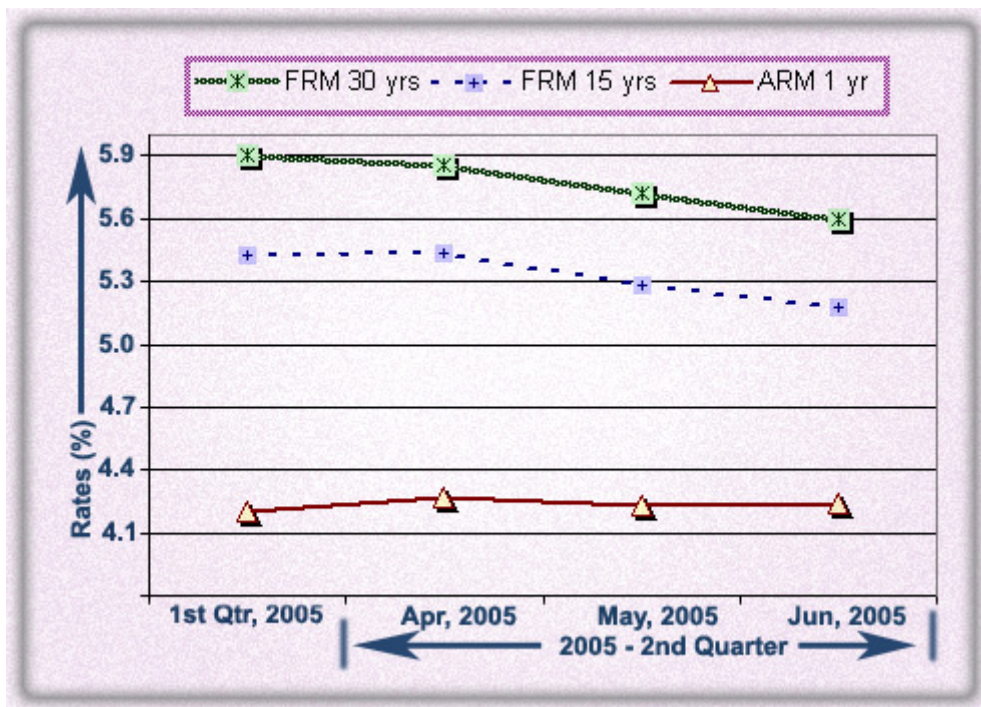
## 2nd Quarter 2005

### Rates dip 14 month low, fosters new housing demand

Mortgage rates had gone up in the first quarter but this did not hinder the growth of the industry and housing market. However, long term rates recorded a slowdown in the second quarter thereby enhancing the growth of refinance applications. But the housing market could not benefit much from the low rates. Even then, housing affordability remained favorable amidst rising home prices.

At the beginning of the second quarter, the average commitment rate on 30 year conventional fixed rate mortgages came down from 5.93% in March to 5.86% in April. This further stimulated existing home sale activities including that of single-family and condos with

42 states showing higher sales compared to last year. West Virginia recorded the highest sales activity with the second-quarter level



of sales activity going up to 21.7% in comparison to the second quarter, 2004. However, on an overall basis, housing affordability for first time buyers declined with the index falling to 70.1 from a reading of 76.8 in the previous quarter.

But the dip in the 30 year fixed rate mortgages to a 14 month low in June 2005 increased housing demand and housing sales activity at the end of this quarter. More and more home buyers attempted to go for adjustable rate mortgages (ARM) on account of low initial-rate discounts or teaser rates offered on these loans. With an average starting rate of 4.24% recorded on 1 year ARM, these variable rate products registered an average fully indexed rate of 6.24%. This was the highest initial-rate discount on 1 year adjustable

rate mortgage. Unlike the 1 year ARM, the 5/1 year adjustable rate mortgage remained in between 5.30% and 5.07% throughout the second quarter.

Along with low fixed rate mortgages, availability of teaser rates on adjustable rate mortgages helped to maintain housing affordability despite rising home prices. Moreover, availability of flexible payment options including interest-only payment plan, and hybrid ARMs helped in increasing the ARM loan originations with the entire volume adding up to one-third of the primary market production.

The second quarter also experienced a growth in refinance loan originations with interest rates on 30 year fixed rate mortgages dipping lower. There was an emerging trend of cashing out home equity before rates could go up further in the upcoming quarters. But as a whole, refinance applications came down to 42% from 45% as recorded in the preceding quarter. However, refinancing helped homeowners in saving a considerable amount on their mortgage payments as a result of rates being lowered by an average of 0.67 percentage points.

### **Conclusion:**

With low rates being offered on fixed rate mortgages along with higher discounts on the initial ARM rates, borrowers relied on mortgage as a favorable financing technique for home purchase or refinance. The housing market boosted up at the beginning of the first quarter but gradually slowed down with average effective mortgage rates moving up from 5.77% in the first quarter to 5.83% this quarter. But on the whole, mortgage rates remained at affordable levels so that borrowers could get the maximum benefit by availing various payment options.

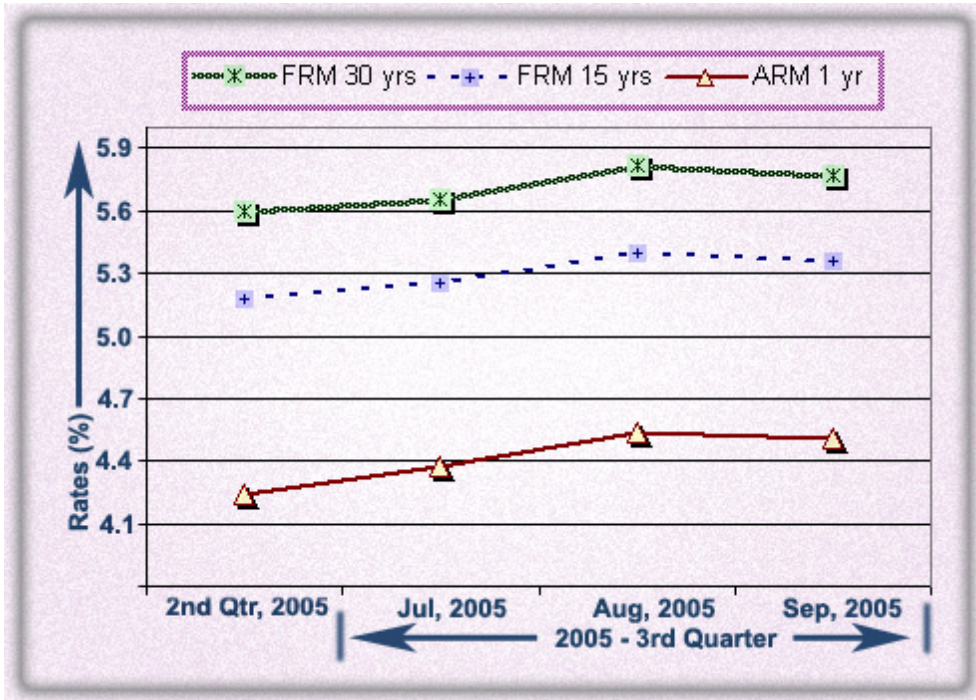
[Back to Index](#)

## 3rd Quarter 2005

### Rates shoot up amidst hurricane disasters

Mortgage rates in the second quarter of 2005 remained favorable with fixed rate mortgages being offered at rates below 6% and adjustable rate products coming along with teaser rates to lure customers with attractive offers. But the third quarter rates experienced a continuous rise with the Federal Reserve raising the short term rates almost every week.

Interest rates on 30 year fixed rate mortgages remained low at around 5.76% in the third quarter but the prime rate influencing home equity lending and lines of credit moved up to 6.75%. Expecting that the prime rate



would be raised further, more and more homeowners utilized their home equity to take refinance loans in order to finance projects related to home improvement.

Refinancing became a popular option with refinance applications accounting for 44% of new mortgage applications. Refinancing of fixed rate mortgages helped homeowners lower their interest rate at an average of 0.57 percentage points unlike the previous quarter when they could reduce the rates at 0.67 percentage points. Even then, the extra cash obtained through refinancing and the lower mortgage payments fueled consumer spending and economic growth to some extent.

The weekly average rate applicable on fixed rate mortgages and 5/1 hybrid ARMs climbed by 3/8<sup>th</sup> of a percentage point from the beginning of July to the end of the third quarter. The upward trend in interest rates and the disastrous effects of hurricanes

Katrina, Rita and Wilma accounted for higher construction costs. Even then, experts predicted a favorable housing market with housing sales and single-family housing starts remaining at satisfactory levels. The housing market flourished in Arizona which registered home value gains of 31.3% throughout the third quarter. But the slowest appreciating market could be found in Michigan, where the home values climbed 4.1%.

The Federal Reserve raised the short term interest rates to the highest mark in comparison to the past 4 and ½ years. There was several such rate hikes intended to keep inflation under control. This had a profound influence on the interest rates applied on other mortgages. In the phase of rising rates, creative mortgage products like interest-only mortgages and option ARMs with teaser rates as low as 1% made way to the mortgage market and this helped to offset the decline in housing affordability. 40 year mortgages became quite popular in certain areas where housing affordability had declined, as these home loans came along with lower monthly payments compared to traditional 30 year fixed rate mortgages.

However, strong economic growth in spite of the hurricane disasters Katrina, Rita and Wilma, and rising inflationary measures from the energy sectors urged the Federal Reserve to raise the benchmark Federal Funds by one-quarter of a percentage point, to 4%. This in fact affected other mortgage rates as the prime rate rose 7% thereby raising the rates applicable on adjustable rate mortgages. Along with a rise in the prime rate, the fixed rate mortgages climbed to 6.3% as a result of strong third quarter GDP figures and the possibility of higher inflation. Supplementing the growth in economy was the growth in income that continued to raise the demand for housing opportunities despite increased construction costs.

### **Conclusion:**

The bond markets recorded a modest fall as the Federal Reserve raised short term rates twice during the third quarter. The US economy continued to grow at an annual rate of 3.7%, with Inflation related to energy costs recording a 4.7% growth at the end of September. In order to fight inflation, the Federal Reserve raised the target Fed Funds rate twice by quarter of a point although the overall rates remained below historic averages and this enabled in the creation of a favorable borrowing environment.

[Back to Index](#)

## 4th Quarter 2005

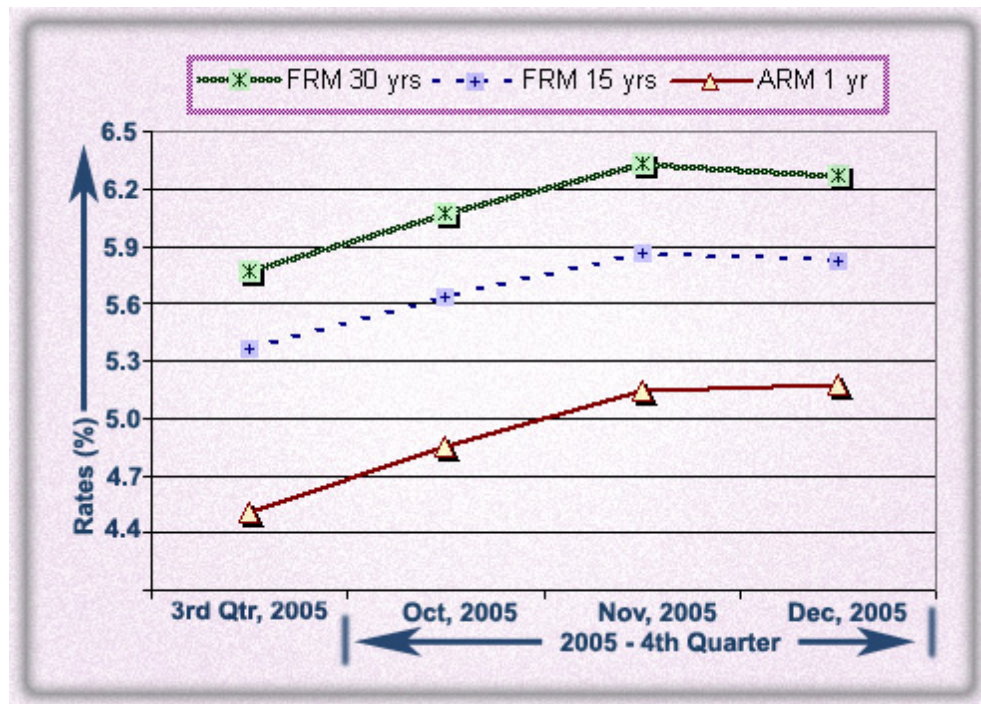
### Fed raises rates again, housing market declines

US mortgage rates in the 3rd quarter experienced a rise in the pre-Katrina period, but dipped down just after the disaster. However, rates edged upwards to its initial level within a short period after the hurricane. The disastrous effects of hurricanes Katrina, Rita and Wilma could not deter the growth in economy and in the aftermath of these calamities, building construction and home repair projects moved up despite the rise in the construction costs. Such a combination of economic growth and rising pressures from the energy sectors have urged the Federal Reserve to push up the Federal Funds Rate to 4% in the fourth quarter.

An upward movement in the Federal Funds Rate influenced the Prime Rate based on which rates on home equity lines of credit and adjustable rate mortgages vary. The contract rates on 1 year ARM moved up to 5% for the first time since March 2002. This had an indirect effect on long term interest rates whereby 30 year fixed rate mortgages climbed up to 6.3% in reaction to the possibility of higher inflation.

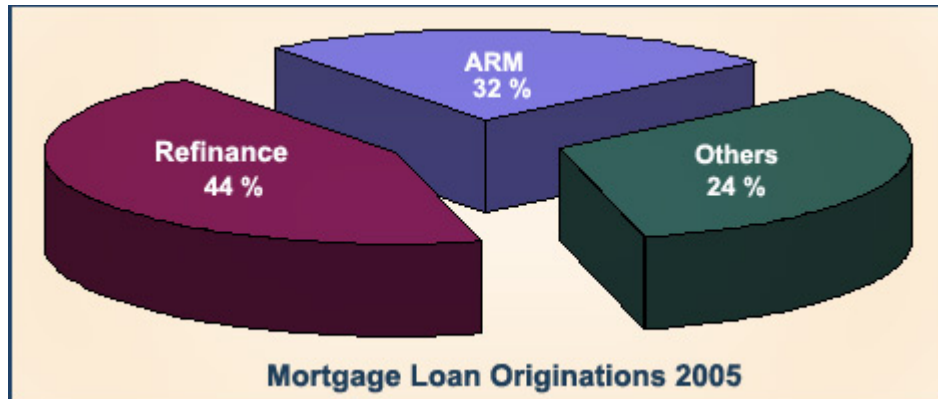
Yields on 30 year fixed rate mortgages came up to an average of 6% at the beginning of October – the highest rate recorded since April. Such a rise in long term

rates was mainly due to an increase in the yields on 10 year Treasury note to around 4.35% - 4.40%, 40 basis points above their



lowest levels just after the Katrina disaster.

Long term rates had moved up to the highest levels in more than a year in response to the probability of higher inflation and increased prospects of Fed tightening over the next 6 years. With the spread between the FRM and ARM reducing to 121 basis points in early October, the ARM share of applications in the prime conventional mortgage market had declined as well. But the ARM share of loan applications had rebounded to 31.6% at the end of October due to a lower spread between FRM and ARM rates. There had been an excessive use of exotic mortgages that could result in payment shock or negative amortization and thus result in a high rate of mortgage delinquency.



However, long term rates continued to go up in October, thereby recording the highest level in about 16 months. As a result of rising mortgage rates, purchase and refinance loan applications in October were at their lowest level since the past few months, and some of the hottest housing markets suffered on account of loss in average sales prices.

30 year fixed rate mortgages resumed their climb as they moved up to 6.3% in early November, the highest level since June 2004. This was mainly due to higher expected inflation and changes in the Fed's policy. Short term rates also showed an upward movement, with the yields on 1 year adjustable rate mortgages increasing to 5.10% in early November – the highest level since early 2002.

Short term mortgages remained stable till December 13 when the Federal Reserve again resolved to tighten the monetary policy and raise the Fed Funds rate to 4.25% - the 13<sup>th</sup> rise in the past 19 months. On the other hand, long term rates (30 year fixed rate mortgages) moved in a narrow range in between 6.26% - 6.37% as the yields on 10 year Treasury Notes shifted from 4.40% to 4.65% during that time. In spite of this narrow move, the number of purchase loan applications moved up at the end of the fourth quarter.

## Conclusion:

A sharp rise in long term rates was not much expected, but there were predictions that the ARM rates should continue to increase as the Fed tightened monetary policy. Housing affordability had declined significantly throughout 2005 and financial experts had anticipated that [rising mortgage rates](#) would lower housing affordability even more, although the fall off may not be uniform all across the nation. It is expected that the Federal Reserve would continue to tighten the monetary policy and bring up the Federal Funds Rate up to between 4.50 - 5.00% by the middle of 2006.

[Back to Index](#)

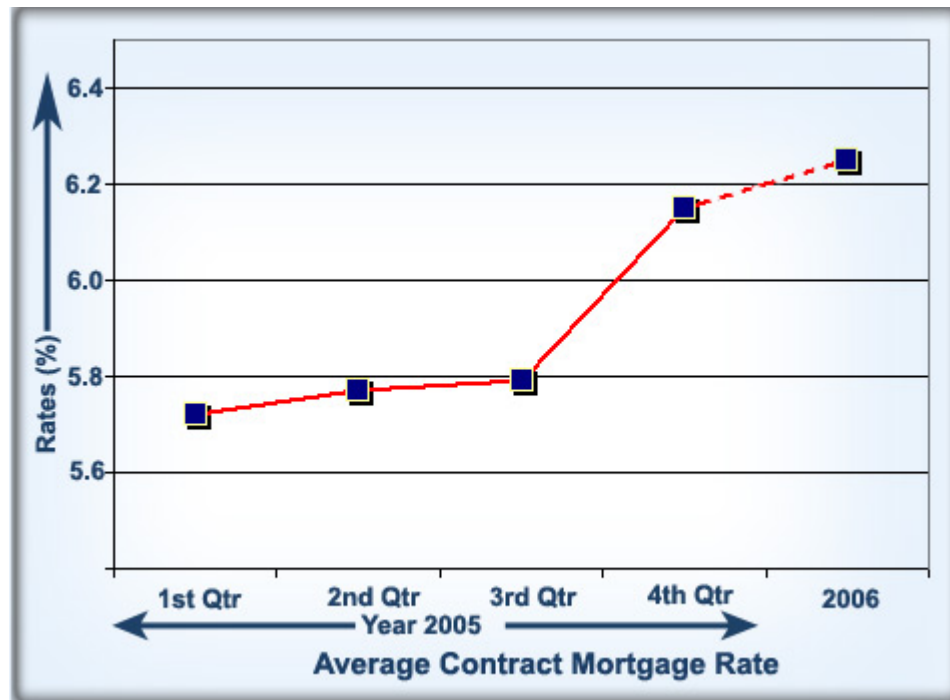
## *Transitioning into the New Year – Rates to continue its upward trend*

2005 seemed to be a busy year for the mortgage industry with the rates going sky high and borrowers with short term mortgages experiencing a hard time with their payments. What we have experienced in the preceding year is a new era in the mortgage industry where rates have gone up to record levels.

The Federal Reserve has been raising the short term rates for the 13th time in a row for the past 19 months. But this is not the end of it. The Federal Funds Rate is likely to move up again to 4.75% by April 2006. But it will depend on inflation and the overall economy which is expected to grow by 3.8% this year.

With the upward movement in the rate of inflation, investors usually demand higher mortgage rates. On the basis of the rates prevailing in 2005, we can expect interest rates to go as high as 7% by the end of 2006 as the Federal Reserve has indicated that short term rates would continue to be on an upward trend this year.

As 2005 ended, 30 year fixed rate mortgages moved up to 6.25% and it is expected that these could further increase by half-a-percent by the end of 2006. With interest rates at higher levels, US home sales are expected to decline by as much as 10% along with a slow down in the purchase originations and refinance activity. Purchase



originations are expected to drop off by 2.3% and refinance activity may fall off to 51.6% in the current year.

Expected economic growth and the Federal Reserve's inclination to push up rates in order to check inflation are likely to move up fixed rate mortgage rates to an average of 6.7% by the middle of this year. Long term Treasury Yields are expected to rise by 0.5 percentage points and this would push up the rates on long term mortgages. Short term rates like that of the 1 year ARM will average around 5.4% later this year in response to the rise in the Fed Funds Rate.

The year 2006 started off with a slight change in interest rates, with fixed rate mortgages going down by 0.01 percent during the first week of January. On the other hand, rates on 5 year Treasury-indexed hybrid ARM have gone down to 5.78% at the beginning of this year. Interest rate savings between 30-year fixed rate mortgages and 1 year ARMs have dropped by 0.6 percentage points to 1% which is certainly going to affect ARM lending activity in 2006.

### **Conclusion:**

Rates on fixed rate mortgages are likely to move up slightly, so this may be the ideal time for you to refinance risky mortgages like ARMs or interest only home loans. The current market scenario is showing signs of warning to homeowners who had opted for risky products during this time last year. Thankfully, there's time enough to refinance these mortgages so that homeowners can cope up with the anticipated rise in rates.

Borrowers going for fixed rate loans should now lock in at the lowest possible rates, or else they may have to come across comparatively higher rates in near future. With short term rates still on the rise, this is the best time to refinance home equity lines of credit with long term mortgages, as rates on these products are quite favorable now. In fact, this is the ideal time to pay off your lines of credit if you have the sufficient cash to deal with it.

**Finally, interest rates are likely to follow the upward trend, so before you take a mortgage, [just watch out for the rates in 2006!](#)**

**[Back to Index](#)**

- **5/1 hybrid ARM:** An adjustable rate mortgage which offers a low introductory rate for the first 5 years of the loan period and then the rate adjusts itself annually with respect to a pre-selected index.
- **40 year mortgage:** A fixed rate mortgage having a loan period of 40 years.
- **10 year Treasury note:** Debt obligation issued by the US Treasury that has a term of more than 1 year, but not greater than 10 years.
- **Adjustable Rate Mortgage (ARM):** A mortgage in which the interest rate and the monthly payments change periodically during the loan period with respect to changes in the pre-selected financial index. Adjustable rate mortgage have caps that limit the increase or decrease in the index.
- **Basis point:** One-hundredth of a percentage point.
- **Cash-out refinance:** A refinance transaction in which the borrower receives an extra cash amount than is required to pay off the existing first mortgage.
- **Condos:** Abbreviation for condominium. A form of ownership of property in which an individual owns a unit of housing in a multi-unit complex apart and also shares financial responsibility for common areas.
- **Contract mortgage rate:** The weighted average of mortgage rates reported for new loan transactions by a sample of lenders.
- **Conventional mortgage:** A mortgage loan not guaranteed by the Federal government (HUD), Veteran Affairs, and Agriculture/Rural Development.
- **Exotic Mortgage:** Home loans designed by lenders to reduce the borrower's payments in the initial years of the loan period.
- **Fed Funds Rate:** Interest Rate at which the depository institutions lend funds at the Federal Reserve to other depository institutions.
- **Federal Reserve:** The Central bank of the United States.
- **Fixed rate mortgage (FRM):** A mortgage loan that charges a fixed rate of interest and hence fixed monthly payments throughout the loan term, which usually ranges from 10 to 40 years.
- **GDP (Gross Domestic Product):** The total value of goods and services produced within an area during a specific period. It is an indicator of the standard of living in that country.

- **Home equity**: The difference between the fair market value of the home and the unpaid balance of the mortgage loan and any outstanding debt taken against the home.
- **Housing starts**: Number of privately owned new homes that have been started over some period.
- **Hybrid mortgages**: A combination of the features of fixed and adjustable rate mortgages. The interest rate charged initially is low and it remains fixed for a period of 3, 5, 7 or 10 years. The rate then varies with respect to an index.
- **Home Equity lines of credit**: A variable rate mortgage against your home equity which allows you to borrow up to certain limit for the loan period. During this period, the home equity line of credit behaves like a credit card with your home kept as the security for the note.
- **Interest-only option**: A payment option that allows you to pay only the interest as the monthly payment for a certain period after which your loan becomes fully amortized for the rest of the loan term.
- **Interest rate**: The cost of borrowing money, expressed as a percentage of the amount borrowed, and calculated over a year.
- **Long term**: A time period of 10 years or longer.
- **Median income**: The average income of a family in a specific geographical area.
- **Monetary policy**: Process of managing a nation's monetary supply in order to fight inflation, achieve full employment or more well-being. It involves setting the interest rates, margin requirements, etc.
- **Monthly payments**: The amount paid on a monthly basis towards the principal and interest amount of a loan. The monthly payment may or may not include the taxes and insurance payments.
- **Mortgage**: A legal document that pledges the property to a lender as the security for the repayment of a loan used to purchase residential or commercial property.
- **Mortgage Delinquency**: The failure to make the mortgage payments within the specified period.
- **Negative amortization**: Method of loan repayment where the borrower pays less than the interest required in each month. The shortfall is then added to the unpaid loan balance.
- **Percentage Point**: A unit expressing the difference between two percentages.
- **Prime rate**: The interest rate banks charge their creditworthy customers.

- **Purchase originations:** Number of mortgage loans originated for the purchase of residential properties.
- **Refinancing:** Paying off an existing mortgage with the proceeds from another mortgage loan taken by keeping the same property as the security for the repayment of the debt.
- **Short term:** A time period of up to 5 years.
- **Teaser Rate:** A low introductory interest rate on an adjustable rate mortgage that is applicable only for the first few years of the loan period.
- **Treasury market:** The US treasury market includes treasury securities such as bills, notes and bonds and other debt obligations issued by the US government. The interest rate offered here is lower than other types of debts.
- **Treasury yields:** The annual return on Treasury bonds, expressed as a percentage. Treasury bonds are long term debt instruments issued by the US government.

[Back to Index](#)

Getting a mortgage with the most reasonable rate is the key to any financial move by a homebuyer. It's also important for anyone looking to refinance their home loans. With frequent changes in the market rates, you need to keep yourself informed with the latest changes.

A preliminary knowledge of mortgage rates and its effects on the industry functioning makes you aware of the risks in getting a mortgage. This e-book provides you with an insight on the following aspects:

- **An outlook of 2004 mortgage rates.**
- **Rate fluctuation in 2005 with the possible causes.**
- **Future expectations of rates - a forecast on 2006 mortgage rates.**

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**Jessica Bennet** is an experienced financial writer associated with the MortgageFit community. She has been helping the community with useful solutions to all financial issues.

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**Our community fits the mortgage to your needs**