All you need to know about the effect of interest rate on Real Estate

ESFS Research

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Table of contents

0. Introduction 2
1. Interest rate and its evolution 2
2. A brief comment on inflation 3
3. General knowledge and definitions 3
4. Technical terms for Real Estate 4
5. Recent changes in mortgages 5
6. Recent changes in housing prices 7
7. Impact of interest rates on Real Estate 8
8. Short-term outlook for the sector 8

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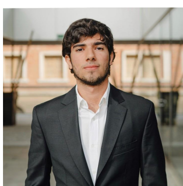

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0. Introduction

One of the industries most exposed to changes in economic policies is real estate. These last few months and years have been no exception. The following article will explain why and how it has been affected and what can we foresee will happen in the following months. The main ideas to be presented are a brief explanation on interest rate and its evolution, some common and less common definitions, followed by an analysis of the housing market in the last couple of years, and finally, a short-term outlook and conclusion. The goal of this piece is to help you better understand better how the market is affected, and what the future holds.

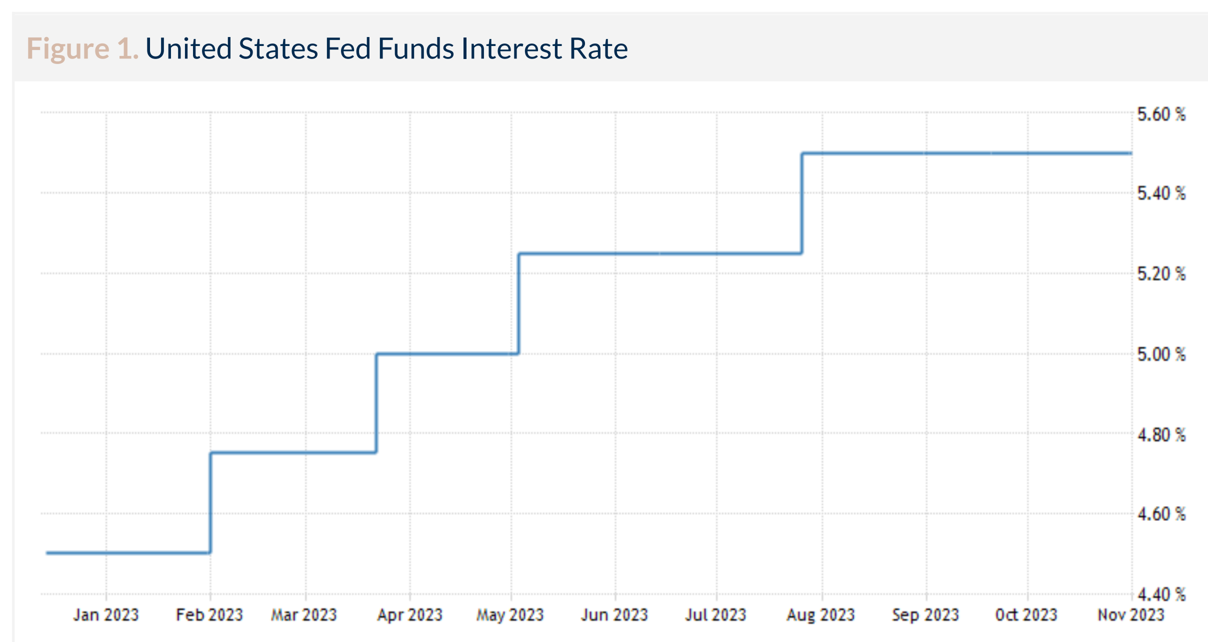
1. Interest rate and its evolution

The benchmark interest rate is the rate at which the Federal Reserve (Fed from here on forward) lends money to banks. It varies depending on the monetary policy, contractionary or expansionary. This has further implications for the interest rate banks offer consumers, which consequently increases or decreases.

The contractionary monetary policy in the US has raised the benchmark interest rate to its highest point in 22 years.

This mechanism established by the Federal Reserve intends a drop in inflation by increasing consumer borrowing costs. Consequently, a greater cost to acquire debt, in turn, is expected to reduce consumption.

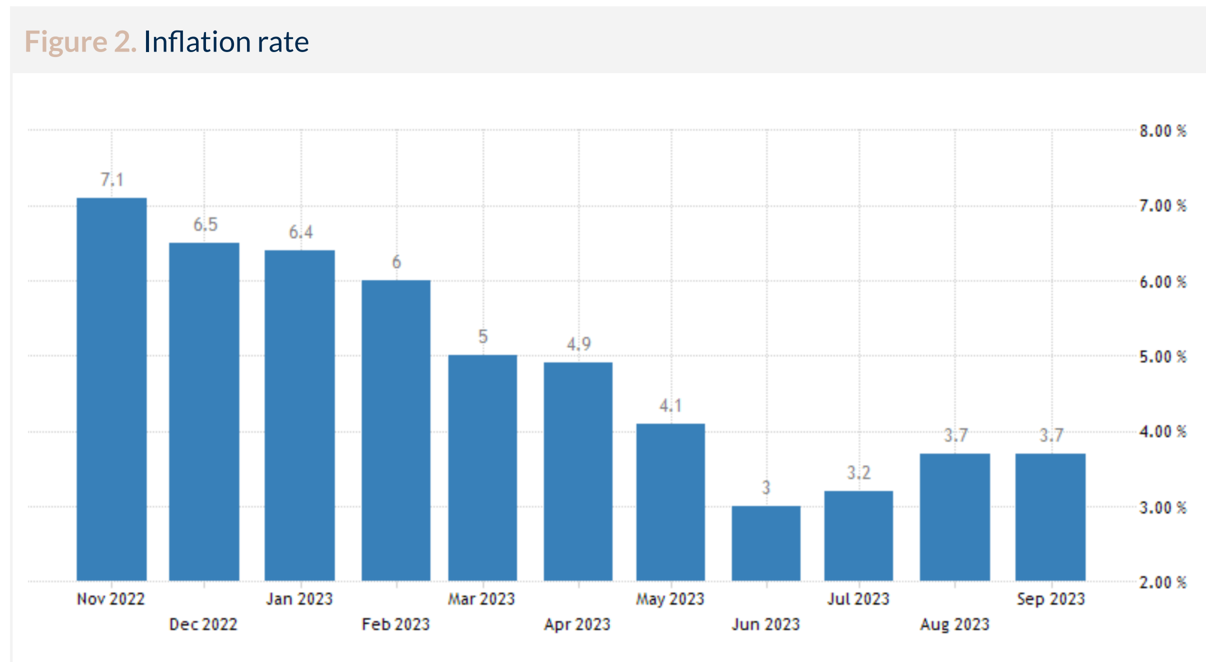
Figure 1. United States Fed Funds Interest Rate



2. A brief comment on inflation

In particular, there has been an upward trend since the beginning of 2023 driven by the commitment of the Fed to reach target inflation of 2%. The Federal Reserve has gradually raised the interest rates from 4.5% in January to 5.5% in November. However, the increase in the interest rates has yet to help reach the previously mentioned target of 2% inflation.

Figure 2. Inflation rate



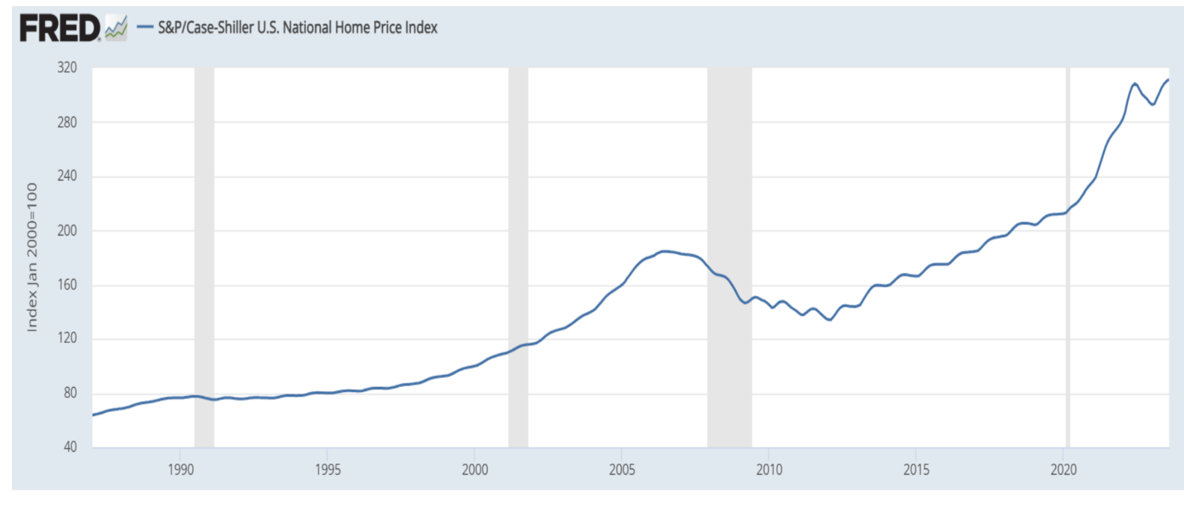
Furthermore, there was a decrease in inflation in the first semester of the year, reaching 3%. However, core inflation remains elevated despite the mitigation policies. The effects of the monetary policy are yet to appear. A new increase or, in any case, sustained economic tightening is expected.

Undoubtedly, pivotal sectors of the economy will be affected. Amongst these, the real estate market is known to rely heavily on monetary policy.

3. General knowledge and definitions

Real estate is a multifaceted asset encompassing land and buildings, playing a pivotal role in the economy. It includes diverse types such as residential properties, which provide living spaces, commercial and industrial properties for business and manufacturing purposes, and undeveloped land that holds potential for future development. The value and utility of these real estate types are greatly influenced by economic factors like bond yields, interest rates, and broader market trends.

Figure 3. United States National Home Price Index

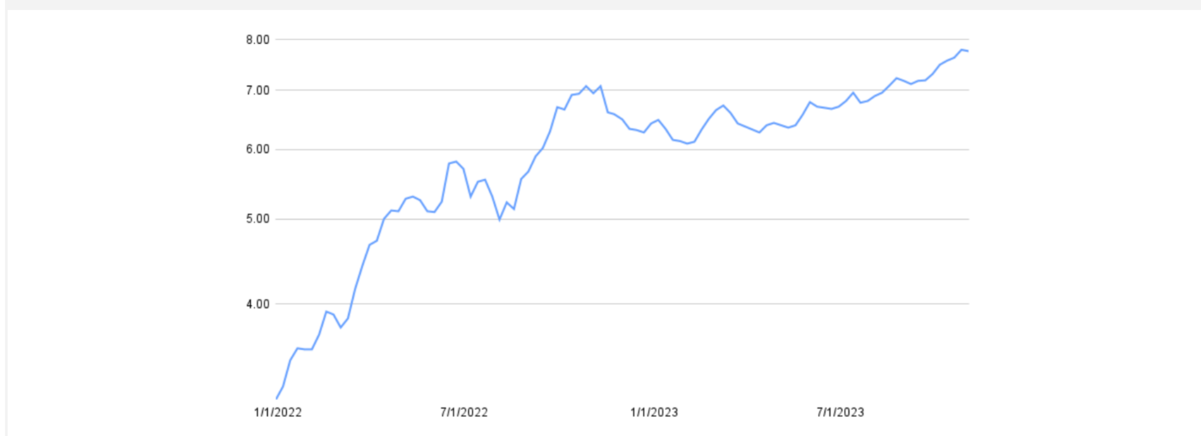


Take, for instance, a metropolitan city where residential properties are in high demand due to a booming population. Here, real estate plays a crucial role in providing housing solutions. In contrast, in industrial zones, the focus shifts towards warehouses and factories, highlighting the sector's versatility.

4. Technical terms for Real Estate

Mortgages, a cornerstone in the real estate sector, greatly facilitate property ownership. There are primarily two types: fixed and variable mortgages. Fixed mortgages offer stability with unchanging interest rates throughout the loan term, providing a shield against market fluctuations. This type of mortgage is particularly appealing during times of economic uncertainty, where predictability in financial obligations is paramount. For example, consider a family securing a fixed-rate mortgage for their home during a period of volatile interest rates. This approach ensures their monthly payments remain constant, regardless of market changes.

Figure 4. Current 30-Year Mortgage Rates: 2022-2023



Whereas, variable mortgages are more dynamic, with interest rates fluctuating in response to market conditions. They can offer savings during periods of decreasing rates but also pose risks when rates increase. A business opting for a variable mortgage might benefit from lower payments in a declining rate environment, but they also face the risk of increased costs if rates rise.

Another important term is the House Price Index (HPI), an essential tool in real estate. It acts as a barometer for the sector's health by tracking changes in residential property prices. This index is influenced by broader economic factors, including the bond market. A rising HPI generally signals robust economic conditions, indicative of a thriving real estate market and a strong overall economy. Conversely, a declining HPI may point towards economic downturns or market instability.

In the realm of specialized financial tools in real estate, Home Equity Lines of Credit (HELOCs) stand out. They offer homeowners flexibility by allowing them to borrow against their home equity. The interest rates on HELOCs are often tied to market conditions, reflecting changes in the bond market. Amortisation, another key concept, refers to spreading out a loan into scheduled payments over time, significantly affecting the total interest paid over the life of a mortgage. It's closely tied to prevailing interest rates.

Concurrently, the Federal Reserve launched the Term Asset-Backed Securities Loan Facility (TALF), a financial instrument backed by loan pools that included credit card debt, student loans and Small Business Administration (SBA) guaranteed loans. Their aim was to supply liquidity to the market for asset-backed securitization in order to maintain credit availability for both individuals and companies.

Lastly, foreclosure is a critical aspect in real estate. It occurs when borrowers fail to meet mortgage obligations. This process can profoundly impact both the housing market and the broader economy, especially during economic stress periods. A wave of foreclosures can lead to a decline in property values and contribute to broader economic challenges.

5. Recent changes in mortgages

In the past few years, due to changing economic conditions, mortgage rates have been constantly fluctuating. The onset of the Covid-19 pandemic in 2020 and 2021 introduced unprecedented challenges that significantly impacted the overall economic landscape. A notable outcome of this situation was the historic decline in mortgage interest rates, which was mostly brought about by the Fed's emergency measures. The main goal of these was to reduce dysfunction in the Treasury and mortgage-backed securities markets, which are essential to the economy's overall credit flow.

In March 2020 the Fed initially committed to purchasing $200 billion in mortgage-backed assets and at least $500 billion in Treasury securities during the subsequent months. Days later, it initiated open-ended purchases, emphasizing its commitment to acquire securities "in the amounts needed." This announcement was an important turn in the Fed's quantitative easing approach and aimed to maintain both the integrity of the market and the efficient implementation of monetary policy.

In June 2020, they showed flexibility in responding to changing economic conditions by setting monthly purchase rates of $80 billion in Treasuries and $40 billion in residential and commercial mortgage-backed securities. The purchase program successfully achieved the Fed's objective of restoring smooth function in the mortgage-backed securities market, since MBS yields quickly dropped and retail mortgage rates reversed, resulting in a steady drop in the cost of financing a house purchase or refinancing.

Thanks to the implemented measures, the Fed successfully lowered mortgage rates to historically low levels, remaining under 3%. However, as inflation rates soared in 2022, this rate unexpectedly changed. Due to their strong correlation with economic data, mortgage interest rates surged sharply to levels not seen since 2002. Freddie Mac data shows a significant increase from 3.22% in January to an astounding 7.08% by October, indicating the effect of inflation on the housing market.

Figure 5. 30-Year Mortgage Rate 2019-2023

Despite expectations for a reversal in 2023, mortgage rates continued to fluctuate within the 6% to 7% range throughout the year. In September, rates reached just above 7%, and by November, they had escalated to the mid-7% range, marking the highest rates recorded since the year 2000.

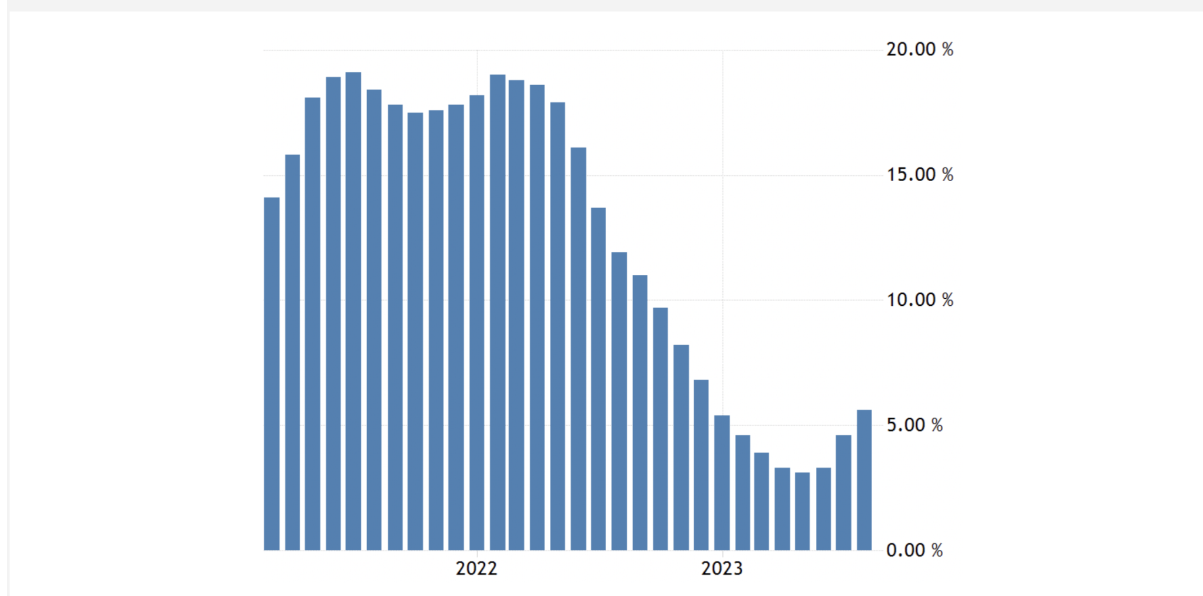
But, as of now, the 30-year mortgage rates have started to descend since mid-November, aligning with the fluctuations that have taken place during the past year. Therefore, although they remain high compared to a few years ago, improved economic data and signs of cooling inflation have caused rates to fall, leading to a decrease in 30-year fixed mortgage rates and consequently increasing home loan applications.

6. Recent changes in housing prices

Mortgage rates affect how much consumers pay to borrow money in order to purchase a home. Consequently, low interest rates tend to increase demand for real estate, which helps appreciate the house itself. High interest rates do normally act in the opposite effect.

As mortgage rates were rising during 2022 due to inflation, the House Price Index (HPI) indicated a reduction in home prices over the year. The median home prices in January and December 2022 provide evidence of these shifts. The average cost of a home was $405,000 in the second quarter of 2022 but declined to $375,000 in the fourth quarter.

Figure 6. House Price Index YoY 2022-2023



With still high mortgage rates in 2023, the prices maintained their negative tendency, with a median price of $373,0008 in the first quarter of 2023, slightly below the previously mentioned value at the end of 2022. However, it should be noted that mortgage rates have begun to decline in November, which can be connected to the recent rise in house prices. With mortgage rates lower, it is now more appealing for consumers to purchase a home.

7. Impact of interest rates on Real Estate

Interest rates have a significant relationship with various aspects of real estate. Rising interest rates lead to low activity in the real estate market, as they make buyers' ability to qualify for a mortgage more difficult and inevitably lead to a decrease in demand in the housing market. In contrast, as mortgage rates decrease, homebuyers tend to become more confident and are more willing to purchase new homes.

This mechanism has a direct effect on home prices. Real estate prices vary according to supply and demand. High mortgage rates lead to lower demand and therefore to lower housing prices. Inversely, low mortgage rates lead to a higher demand and an increase in housing prices.

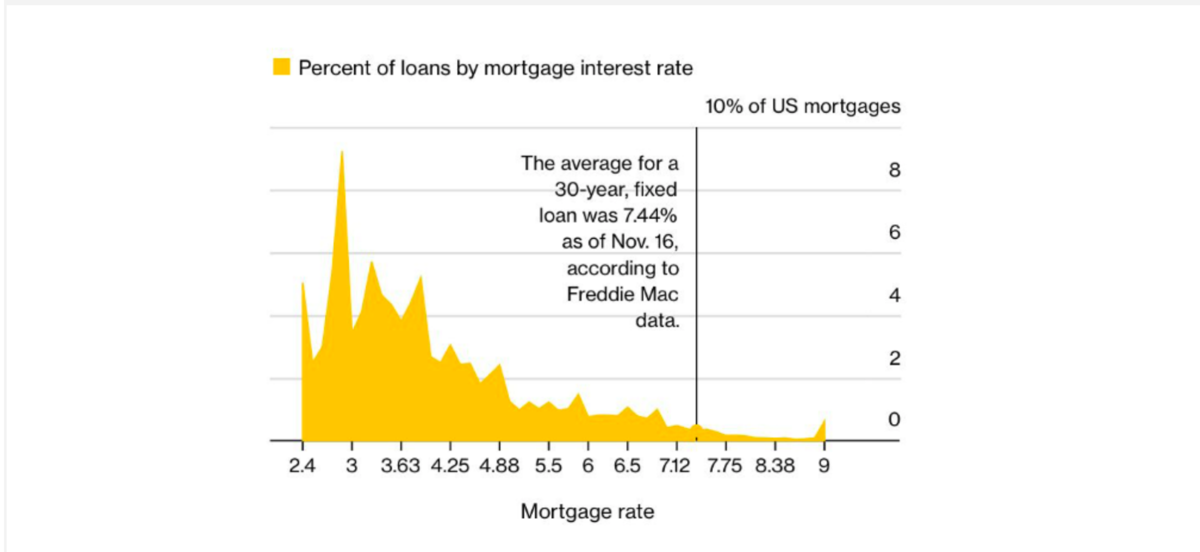
Moreover, interest rates can also have an impact on the rental market both on the landlords and the tenants through direct and indirect effects. On one hand, with higher interest rates, landlords seem to become mortgage prisoners, a situation even more emphasized when rates are variable. In contrast to fixed mortgage rates, variable mortgage rates make monthly payments subject to changes. Through variable mortgage rates, landlords' borrowing costs and monthly payments rise, making their profitability and cash flow more difficult. With significant increases in their monthly payments, landlords are likely to have to pass their increased costs to their tenants through higher rents. This would lead to two different scenarios. First, in case of a new tenant caught in the struggle of finding a rent, he or she will have to absorb the cost. However, many tenants cannot afford an increase, leading to landlords seeking to sell some of their properties at the expense of making tenants homeless as other rental properties are under the same widespread interest rate effect. As for old tenants, due to prior tenancy agreements limiting the scale and the frequency of the rent increases, landlords will have to cover most of their increased costs themselves, leading to less profit.

While interest rates directly affect the rental market, rising interest rates can also have an indirect impact. Indeed, as home prices rise, people tend to seek for rentals, adding pressure to the small amount of rent supply. As a result, landlords will not have to lower their prices to attract new tenants as according to the law of supply, with increasing demand, landlords will be tempted to increase their prices.

8. Short-term outlook for the sector

During 2023, mortgage rates have reached their peak in over 20 years. According to the National Association of realtors, during the week of November 16th, mortgage interest rates have dropped to 7.44% from 7.50% the week before. This drop can be interpreted as a sign that the rate has reached its maximum and will now slowly decrease. One main factor at the origin of this increase is the Federal Reserve raising Federal Funds Rates as a tool to influence the economy and reduce inflation, therefore having a direct effect on mortgage rates. The Fed's goal is to keep inflation at an annual rate of 2%.

Figure 7. Current Mortgage Rate & Effect on the Market



The central bank has announced that it plans to keep the mortgage rates high for as long as it needs to achieve that 2%. According to the CMEFedWatch Tool, there is a 50% chance that the Fed will cut federal funds rates by May 2024, leading to a decrease in mortgage rates. However, these rates leveling down will take place progressively due to the volatility of the market caused by geopolitical events such as a possible government shutdown in the United States or Israel's war against Hamas which could make rates increase once more. According to Forbes, mortgage rates will average 6.3% in 2024, with a range of 5.9% to 6.7%.

A decline in mortgage rate may allow a certain relief for homebuyers and sellers, who will be able to act more freely. However, competition may also arise as homebuyers try to take advantage of lower mortgage rates.

The effects of interest rate on the real estate market are a trending topic nowadays. Articles, such as Bloomberg's "High Interest Rates Are Crushing the Global Real Estate Market", help keep up with the latest insights and further develops the points explained here.

First American Financial Corporation chief economist Mark Fleming.

"It's likely that mortgage rates continue to hover in the 6.5% to 7.5% range for the remainder of the year, which means affordability will remain a challenge for many home buyers."

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