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Will Rising Rates Kill the Housing Recovery?

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On June 19, 2013 Treasury yields spiked after Fed chairman Ben Bernanke stated the Fed will begin tapering QE3 later this year *if* the economy and employment continue to improve as the Fed expects. Here is what Bernanke said: "Going forward, the economic outcomes that the Committee sees as most likely involve continuing gains in labor markets, supported by moderate growth that picks up over the next several quarters as the near-term restraint from fiscal policy and other headwinds diminishes. We also see inflation moving back toward our 2 percent objective over time. If the incoming data are broadly consistent with this forecast, the Committee currently anticipates that it would be appropriate to moderate the monthly pace of purchases later this year. And if the subsequent data remain broadly aligned with our current expectations for the economy, we would continue to reduce the pace of purchases in measured steps through the first half of next year, ending purchases around midyear. In this scenario, when asset purchases ultimately come to an end, the unemployment rate would likely be in the vicinity of 7 percent, with solid economic growth supporting further job gains, a substantial improvement from the 8.1 percent unemployment rate that prevailed when the Committee announced this program." [1]

According to Bloomberg and Reuters, the 10-year and 30-year Treasury yields reacted swiftly by jumping to levels that prevailed in late 2011.[2, 3, 4] Mortgage rates, which had already been rising since late 2012, took another hike. Data from Freddie Mac showed that the weekly average rate as of June 20, 2013 for the 30-year fixed rate mortgage (FRM) was 3.93%, up from around 3.35% in early May 2013 and the record low of 3.31% reached in November 2012. The 15-year FRM rose from an average of 2.56% in early May this year to an average of 3.04% for the week ended June 20, 2013. Over the same period, the 5-year Treasury-indexed hybrid adjustable-rate mortgage (ARM) also increased from an average of 2.56% to an average of 2.79%.[5]

Bond and stock markets sold off as investors reacted to the prospect of higher interest rates, with interest-rate sensitive sectors like the homebuilders and REITs among the hardest hit. Will rising rates indeed kill the housing recovery, as the market fears? We don't think so.

Rising rates so far have not hurt housing

Let's first look at the anecdotal evidence. Even before the Fed's most recent June statement on tapering QE3, most mortgage rates have already been trending up since late 2012. The table on the next page shows that housing demand continues to be robust in face of rising FRM. It is important to note that sales would have been even greater had existing and new housing inventory not been supply-constraint.

The National Association of Realtors (NAR) reported that the number of existing homes sold in May 2013 was at the highest level since November 2009, when sales jumped because of the first-time homebuyers' tax credit.[6] As another noteworthy data point, Mortgage Bankers Association's unadjusted Purchase Index rose 1% in the week ended June 21, 2013 for a year-over-year gain of 16%. Although refinance application volume for the same week fell to its lowest level in almost 2 years, applications for conventional purchase loans gained 3% over the week and total purchase applications were up 16% from a year ago.[7] Rising rates will hurt refinancing volume more than purchase volume, but purchase activity is the greater contributor to the housing recovery.

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Month	Monthly Average Commitment Rate for Conventional, Conforming Mortgage		Existing Home Sales		New Home Sales	
	30-year FRM	15-year FRM	Units sold in thousands, seasonally annualized	Median price	Units sold in thousands, seasonally annualized	Median price
Dec. 2012	3.35	2.66	4,900	$180,200	396	$258,300
Jan. 2013	3.41	2.70	4,940	$170,600	458	$251,500
Feb. 2013	3.53	2.77	4,950	$173,200	445	$265,100
Mar. 2013	3.57	2.76	4,940	$183,900	451	$255,000
Apr. 2013	3.45	2.66	4,970	$191,800	466	$272,600
May 2013	3.54	2.72	5,180	$208,000	476	$263,900

Source: Freddie Mac, National Association of Realtors, and US Census Bureau

Why has the rise in rates over the past few months not brought the housing recovery to a screeching halt? Will a further likely rise over the next 12 to 24 months put a nail in the housing rebound? Below we analyze these questions.

Health of Housing Market Depends on Multiple Factors

The health of the housing market depends on multiple counteracting factors. Interest rates are a very important variable affecting housing demand, because they impact the cost of financing a house purchase. *All other things being equal and taken in isolation*, rising rates hurt housing demand. But all other things are not equal; there are many other significant variables that affect housing demand, such as level of employment, confidence, and housing supply. Currently, the media is overly focusing on the single variable of interest rates, while downplaying or ignoring the other counteracting variables. Let's go through these variables.

Employment and the Economy

Look again carefully at Ben Bernanke's statement above. He did not say that taper will happen for sure or automatically; the Fed won't taper unless the economy continues improving per the Fed's forecast. This means that tapering (negative) will occur only if the economy and employment improve (positive). Importantly, the stated conditions for tapering are the counteracting positive factors of economic and employment improvement, both of which are powerful contributors to housing demand. Also, the Fed has consistently over-estimated the strength of the economy and employment on the way down going into the Great Recession and during the subsequent recovery. Will the Fed's optimistic forecast this time around be any more accurate?

Interest Rates Likely to Rise Gradually Over Time

Gradual rate hikes hurt housing demand less than quick spikes. After the initial panicky reaction to the prospect of tapering, we expect rates to settle down to a more gradual incline. This is because the Fed has indicated that it intends to keep short-term rates low. Further, tapering means still adding liquidity to the economy, though at a reduced rate, as "[the Fed] would not be shrinking the Federal Reserve's portfolio of securities, but only slowing the pace at which [the Fed is] adding to the portfolio while continuing to reinvest principal payments and proceeds from maturing holdings as well [emphasis added]." [8]

At its June meeting, the Fed stated its intention to keep the target range for the federal funds rate at 0-0.25% and "currently anticipates that this exceptionally low range for the federal funds rate will be appropriate at least as long as the unemployment rate remains above 6-1/2 percent, inflation between one and two years ahead is projected to be no more than a half percentage point above the [FOMC's] 2 percent longer-run goal, and longer term inflation expectations continue to be well anchored [emphasis added]."[9] We are a long way from 6.5% unemployment, and this target will be even more difficult to hit if improving employment encourages people to re-enter the labor force.

Bernanke further stated that "14 of 19 FOMC participants indicated that they expect the first increase in the target for the federal funds rate to occur in 2015, and one expected the first increase to incur in 2016 [emphasis added]."[10] Also, "increases in the target for the federal funds rate, once they begin, are likely to be gradual [emphasis added]," so long as maximum employment is not yet reached and inflation is near 2%.

Importantly, the Fed showed flexibility by explaining that if its estimates on economic growth turn out to be overoptimistic, "reductions in the pace of [asset] purchases could be delayed," and if needed the Fed would be prepared to "employ all of its tools, including an increase in the pace of [asset] purchases for a time." [11]

Mortgage Rates Are Still Historically Very Low

Though mortgage rates have climbed in response to the prospect of QE3 tapering, they are still at historically low levels, as shown in the table below.

Mortgage type	Average rate for the week ended 6/20/2013	Lowest monthly average rate before 2008 (i.e. before Fed intervention)	Lowest monthly average rate on record
30-year FRM	3.93%	5.23% (June 2003)	3.35% (Nov. & Dec. 2012)
15-year FRM	3.04%	4.63% (June 2003)	2.66% (Nov. & Dec. 2012; Apr. 2013)

Source: Freddie Mac

Here's some perspective on how much rate increases hurt borrowers. For example, the fully amortizing monthly payment for a $300,000 30-year FRM would be $1,347.13 if the mortgage rate is 3.5% (which is pretty close to the monthly average found in Freddie Mac's Primary Mortgage Market Survey in each month between January 2013 and May 2013). If the rate rises to 4%, the monthly payment would increase to $1,432.25, or an increase of about $85 per month. This is unlikely to turn away most potential home buyers, and in fact might help get them off the fence.

Powerful Demographics

As noted in the Joint Center for Housing Studies of Harvard University's study "The State of the Nation's Housing 2012," all main government surveys agree that household growth has slowed dramatically since the recession.[12] Specifically, the average annual household growth between 2007 and 2011 was just 568,000, less than half the pace in the first half of the 2000s and the 1.15 million averaged in the late 1990s. This is mainly the result of fewer young adults forming new households and fewer immigrants coming to the U.S., due primarily to the recent economic downturn. The significant amount of household formations that was postponed during the recession will be a major driver of housing demand in the coming years.

Severely Limited Housing Inventory/Supply

Although the new homes available for sale, building permits as well as housing starts have continued picking up, they are still *far below* the levels seen during more normalized conditions before the housing bubble years, as shown in the table below. To meet pent-up demand for housing, many new houses will have to be built.

According to NAR's data, the number of existing homes available for sale at the end of May was roughly 2.22 million units, or a 5.1-month supply at the current sales pace. This is down from 5.2-month in April 2013 and 6.5-month a year ago. Lawrence Yun, NAR chief economist, commented on June 20, 2013 that limited supplies can be expected across the country in the rest of the year, with the number of homes available for sale unlikely to grow "unless new home construction ramps up quickly by an additional 50%."[13] As prices rise, inevitably some homeowners who were upside down on their houses will release product into the market. This is not necessarily a bad thing; in fact, it may help prolong the housing cycle, since anecdotally there are bidding wars around many parts of the country. For instance, according to Redfin's latest data, while competition in San Francisco and Los Angeles has cooled a bit in May 2013, these two markets remain very competitive—87.9% and 86.1% of the offers written by Redfin agents in San Francisco and Los Angeles, respectively, faced multiple bids.[14]

Housing Units Authorized by Building Permits, Housing Units Started, and New Houses For Sale (units in thousands)

Annual Data				Seasonally adjusted (annualized)				
Year	Permits	Starts	For sale	Year	Month	Permits	Starts	For sale
1997	1,441.1	1,474.0	287	2013	Jan	915	898	149
1998	1,612.3	1,616.9	300	2013	Feb	952	969	152
1999	1,663.5	1,640.9	315	2013	Mar	890	1,005	153
2000	1,592.3	1,568.7	301	2013	Apr	1,005	856	157
2001	1,636.7	1,602.7	310	2013	May	974	914	161
2002	1,747.7	1,704.9	344					
2003	1,889.2	1,847.7	377					
2004	2,070.1	1,955.8	431					
1997-2004 average	1,706.6	1,676.5	333.1	**2013 May vs. 1997-2004 average**		**-42.9%**	**-45.5%**	**-51.7%**

Source: Census Bureau

It is also important to note that the much ballyhooed shadow inventory disaster never came to pass. CoreLogic reported that the overall shadow inventory as of October 2012 was 2.3 million units, down 12.3% year-over-year.[15] In March 2013, CoreLogic reported that the shadow inventory as of January 2013 further dropped to 2.2 million, down 18% year-over-year. Healthy reductions were seen across much of the country, with significant year-over-year declines seen in Arizona, California and Colorado.[16]

Affordability Is Still Very High

Housing affordability continues to be extremely high. Of course, rising rates will hurt affordability, but that is very different from making housing unaffordable. The NAR's Homebuyer Affordability Index (HAI) reached a record high of 210.7 in January 2013. A value of 100 means that a family earning the national median income has 100% of the income necessary to qualify for a mortgage on a median-priced property at the current mortgage rates. The most recent reading was 183.1 for April 2013, which is still very high compared to the past few decades.[17]

According to Rocio Sanchez-Moyano, a research assistant with the Harvard Joint Center for Housing Studies, interest rates are currently so low relative to the historical average that the median-priced homes in a majority of the metros would remain affordable to buyers even with moderate increases in interest rate.[18] Through an analysis that follows the NAR's methodology in calculating their HAI, i.e. a mortgage payment no more than 25% of monthly income is considered affordable, Sanchez-Moyano concluded that mortgage payments on a median priced home were affordable in more than 95% of metro areas in 2012. If mortgage rates rose to 5%, 93% of metro areas would still be affordable.

Conclusion

We do not think that rising rates will kill or severely hinder the housing recovery. While higher rates in isolation clearly hurt housing demand and affordability, all the other powerful counteracting factors discussed in this article should be enough to sustain the current housing rebound for several years.

End notes:

1. http://www.federalreserve.gov/mediacenter/files/FOMCpresconf20130619.pdf
2. http://www.bloomberg.com/news/2013-06-20/treasury-yield-touches-15-month-high-as-bernanke-signals-qe-exit.html
3. http://www.reuters.com/article/2013/06/24/markets-usa-bonds-idUSL2N0F009E20130624
4. http://www.reuters.com/article/2013/06/19/markets-usa-bonds-idUSL2N0EV1VS20130619
5. http://www.freddiemac.com/pmms/
6. http://www.realtor.org/news-releases/2013/06/existing-home-sales-rise-in-may-with-strong-price-increases
7. http://www.mortgagebankers.org/NewsandMedia/PressCenter/84882.htm
8. http://www.federalreserve.gov/mediacenter/files/FOMCpresconf20130619.pdf
9. http://www.federalreserve.gov/newsevents/press/monetary/20130619a.htm
10. http://www.federalreserve.gov/mediacenter/files/FOMCpresconf20130619.pdf
11. http://www.federalreserve.gov/mediacenter/files/FOMCpresconf20130619.pdf
12. http://www.jchs.harvard.edu/sites/jchs.harvard.edu/files/son2012.pdf
13. http://www.realtor.org/news-releases/2013/06/existing-home-sales-rise-in-may-with-strong-price-increases
14. http://www.redfin.com/research/reports/real-time-bidding-wars
15. http://www.corelogic.com/about-us/news/corelogic-reports-shadow-inventory-continues-decline-in-october-2012.aspx
16. http://www.corelogic.com/about-us/news/corelogic-reports-shadow-inventory-down-28-percent-from-2010-peak.aspx
17. http://research.stlouisfed.org/fred2/series/COMPHAI
18. http://housingperspectives.blogspot.com/2013/05/despite-rising-home-prices.html

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