Will Rising Mortgage Rates Douse the Red-Hot Housing Market?

A sharp uptick in mortgage rates is starting to cool an overheated housing market. With more rate hikes on the horizon, many fear that house prices could collapse as they did in 2007. But today's real estate boom is a very different case.

The average 30-year fixed mortgage rate has increased about 2.0% since the start of the year, its fastest pace in over 25 years.

Anyone looking for a house these days faces a long list of shocks. Prices are jaw-dropping in many areas. Bidding wars are common. Sales are often over asking price. Inspections and other contingencies are routinely waived. And now, buyers face an even greater jolt when they apply for a mortgage. That 2% rate that was trumpeted all over the Internet for many months has all but disappeared. Rates are now averaging over 5%, making a monthly payment a lot higher.

In fact, the average rate on a 30-year fixed-rate mortgage has increased about 2.0% since the start of the year -- from 3.11% at year-end to 5.10% as of April 28.[1] That translates into a monthly payment that's $230, or 27%, higher on a $200,000 mortgage -- which works out to an additional $2,760 per year and over $82,000 more over the life of the mortgage.[2]

Needless to say, the higher rates have tempered the enthusiasm of many would-be buyers, who simply can't afford the higher monthly payment. Although real estate markets remain strong, there has been a notable softening in some closely watched metrics. Mortgage applications are down, as are online house searches, and an increasing share of sellers are reducing their prices after putting their homes on the market. According to Redfin, about 12% of homes for sale had a price drop during the four weeks ending April 3, up from 9% a year ago. New listings have also dipped, though inventory remains historically low.

Given the near certainty of more rate hikes by the Federal Reserve in the months ahead, mortgage rates are very likely to creep even higher. The question is not *if* real estate will cool down, but by how much.

Now vs. Then

By any measure, last year's market for residential real estate was exceptional. The median sales price for an existing home rose 17% in 2021 to $346,900 -- a record level and rate of growth. Many areas saw over 20% appreciation, and the average American homeowner realized a gain of over $50,000 in home equity in just one year.[3]

In the months preceding the 2007 housing bust, the froth was similar -- with one big difference. That boom was largely fueled by speculative buying and loose lending practices. People were taking out mortgages that they could not afford, for amounts greater than the value of the property, in the hope of flipping the property. When prices started to cool, the whole scheme fell apart, and prices tumbled.

Today's housing boom is a very different animal. For one thing, Congress put reforms in place to prevent the ruinous lending practices of 15 years ago. The current run-up in house prices is more about burgeoning demand and limited supply. Millennials, who as a group had avoided or postponed home ownership, finally decided that owning was better than renting. Meanwhile, the pandemic shift to remote working inspired millions of Americans to seek more living space or to move to areas where they could get more bang for their real estate buck.

Meanwhile, today's housing inventory remains exceptionally low. As of March 2022, the supply of existing homes for sale totaled only 870,000 units -- less than half the average inventory of 2.3 million units since 1983.[4] The low inventory reflects a dearth of building following the financial crisis, when many homebuilders went out of business. New construction has also been hampered by pandemic-related supply chain disruptions and labor shortages. What's more, raw material costs remain high and builders continue to struggle to keep up with homebuyer demand.

What Lies Ahead

Most experts currently predict a softening in residential real estate rather than a crash, with price appreciation moderating, but still positive. A few predict another year of double-digit growth, but most, including the National Association of Realtors, see a "normalization" of prices -- i.e., single-digit growth. Others expect prices to closely track inflation.

Regardless of their estimates, all stress the importance of mortgage rates. Should rates rise dramatically, sales and prices will suffer. There are also many unknowns. Will inflation get worse? How long will the war in the Ukraine continue and how badly will it disrupt world commerce? And, of course, will another strain of Covid shutter the economy? While a 2007-style crash may not be in the offing, expect these and other factors to moderate today's real estate boom.

[1]FreddieMac, *Mortgage Rates*, April 28, 2022.

[2]Example includes only principal and interest, not closing costs, points, or escrows that may be required by lenders. Your results will differ.

[3]NPR, *Home prices rose faster than ever in 2021. The typical home gained $50,000 in value*, January 20, 2022.

[4]Bankrate, *2022 second-quarter housing trends: Rising rates complicate spring homebuying*, April 1, 2022.