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Rising Rates Join Long List of Housing Dilemmas

In this environment, prospective homebuyers, renters who must renew a lease, or anyone looking for a new place to live could find themselves between a rock and a hard place.

Homebuyers braving the hot U.S. housing market have run headlong into a striking transition. The average interest rate for a 30-year fixed mortgage jumped from around 3.2% at the beginning of 2022 to 5.3% in mid-May, the highest level since 2009. This rise was sparked by the Federal Reserve's commitment to raise the federal funds rate — a key benchmark for short-term interest rates — to help control the highest inflation in decades.[1]

Although mortgage rates are not directly tied to the federal funds rate, all borrowing costs are influenced by the Fed's monetary policies. Mortgage rates tend to track changes in the 10-year Treasury yield, which is sensitive to changes in the funds rate and also fluctuates based on the bond market's longer-term expectations for economic growth and inflation.

Housing Costs Are Soaring

For nearly two years now, buyers have faced an intensely competitive housing market characterized by historically low inventory, bidding wars, and escalating prices. The national median price of existing homes rose 14.8% over the year ending April 2022 to reach $391,200. Home prices are rising in every region, and 70% of the nation's 185 metro areas experienced double-digit annual increases in the first quarter. In a notable shift, price gains in affordable small- and mid-size cities outpaced gains in more expensive urban markets, as many homebuyers seized the opportunity to work remotely.[2]

Home prices and market conditions can vary widely by region and even from one neighborhood to another in the same city. April median prices in the 10 most expensive cities ranged from $662,000 in Denver to $1,875,000 in San Jose. Half of the nation's 10 priciest markets are in California, a state with a particularly severe and longstanding housing shortage.[3]

Rents have been rising with home prices. In April 2022, the median rent for 0- to 2-bedroom properties in the 50 largest U.S. metro areas reached $1,827, a year-over-year increase of 16.7%. Spikes were more dramatic in Sun Belt cities such as Miami (51.6%), San Diego (25.6%), and Austin (24.7%).[4]

In this environment, prospective homebuyers, renters who must renew a lease, or anyone looking for a different place to live could find themselves between a rock and a hard place.

Affordability Is Waning

The combination of rising mortgage rates and home prices has taken a serious toll on affordability. A borrower with a $300,000 mortgage would pay $1,666 per month at a 5.3% rate versus $1,297 at a 3.2% rate, the prevailing rate earlier this year. Affordability is an even bigger issue in high-cost areas and for first-time buyers who haven't benefited from gains in home equity.

Borrowers who started a home search and were prequalified by a lender before rates spiked may not be approved for the mortgages they initially sought. Consequently, demand for adjustable-rate mortgages (ARMs) that offer lower rates has surged in recent months.[5] A lower monthly payment makes it possible to qualify for a larger mortgage, so borrowers who expect to move at some point may be comfortable with an ARM that has a fixed rate for the first three, five, seven, or 10 years of the 30-year term before it adjusts to prevailing rates.

Some buyers will reset their expectations and settle for a less-expensive home. But others may give up the search if they are not satisfied with the homes they can afford, especially if they are priced out of their

favorite neighborhoods. Many entry-level buyers could be forced out of the market entirely, at least for the time being.

Buyers of new homes may be subject to substantial interest-rate risk because purchase contracts are often signed many months before their homes will be completed. With their deposits at stake, buyers might consider paying the extra cost to extend rate locks for six, nine, or even 12 months.

Higher borrowing costs are likely to reduce demand for homes enough to slow price growth, and prices might retreat in some overheated markets. Even so, most economists don't expect home prices to collapse because market fundamentals are otherwise relatively strong. Inventory levels are still extremely low, and lenders have generally been conservative, so most homeowners who bought in recent years can afford their mortgages.[6] Interest rates don't impact cash buyers, such as downsizing retirees and investors, who account for about 26% of transactions.[7] And assuming the economy and employment hold up, there should be plenty of demand from millennials in their peak homebuying years.[8]

Tips for Bewildered First-Time Buyers

Paying rent indefinitely may do little to improve your financial future, but if you are ready to commit to a mortgage, buying a home could stabilize your housing costs for as long as the payment is fixed. You can also build equity in the property as your loan balance is paid off over time — more so if the value appreciates.

Despite much speculation, no one knows for sure where mortgage rates are headed or what will happen next in the housing market. So how can you decide whether it makes financial sense to purchase a home? As always, the answer depends on where you want to live, your lifestyle preferences, and your finances.

Here are three ways to start preparing for the homebuying process.

Become a better borrower. Before you apply for a mortgage, order a copy of your credit report to check for errors and clean up any inaccuracies. Having a higher credit score could earn you a lower interest rate.

Save up for a down payment. Buyers must typically invest 20% of the purchase price for conventional mortgages, but some loan programs allow smaller down payments of 5% to 10%. If parents or other family members offer to "gift" cash for a down payment, lenders may ask for a letter to document the source of funds. There may also be local programs that provide down-payment assistance for buyers who meet income requirements and take classes on homeownership.

Find out how much you can afford to spend. Start with online calculators that take your income, debt, and expenses into account. A mortgage provider can help determine how much you may qualify to borrow. It can take three to five years to recoup real estate transaction costs, so be sure to consider the stability of your employment situation and your income.

1) Bloomberg, May 12 and May 19, 2022

2-3, 7) National Association of Realtors, 2022

4) Realtor.com, 2022

5) *The Wall Street Journal,* May 5, 2022

6) NPR, May 12, 2022

8) *The Wall Street Journal,* December 14, 2021
