Buying a Home in a Rising Interest Rate Environment

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AGENDA

3
Current Real Estate Environment

3
The Great Recession

4
The Housing Market During the Great Recession

5
Post Great Recession

5
Interest Rates

6
Interest Rates and the Housing Market

6
Rising Interest Rates

7
Property Value

7
Real Estate Investments

8
Buy or Rent?

9
About the Author

THE CURRENT REAL ESTATE ENVIRONMENT

Over the last decade, no event has influenced the current real estate environment more than the global economic downturn that began in 2008. Understanding the dynamics and implications of such a massive economic upheaval is critical for home buyers in today's housing market. During this seismic economic shift, referred to as the Great Recession, many if not most people faced a myriad of unprecedented challenges.

The good news for today's home buyers is that the foundational issues of the Great Recession have been addressed by the real estate industry, the financial industry and U.S. policy makers. Overall, interest rates remain lower than historical averages; yet, the current real estate environment will not last forever. It's important to pay close attention to rising mortgage interest rates, especially if you are a first-time home buyer. For many people, mortgage rates are the single most important factor when deciding to purchase a home.

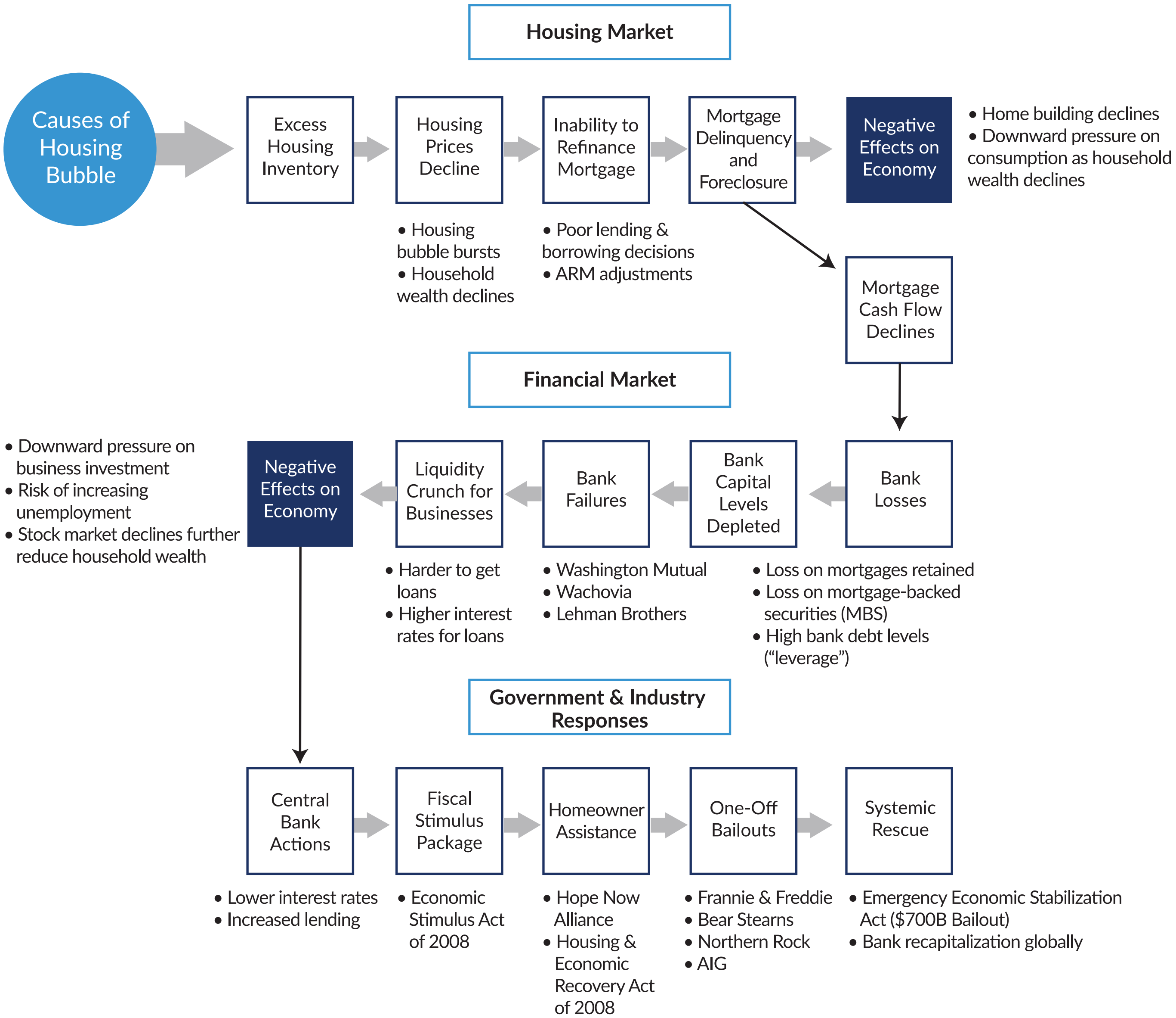
To gain a better understanding of today's housing market, home buyers must know how the Great Recession occurred in the first place – and heed the warnings of the last decade. Given the volatility of our economy today, it is probable that real estate values will at times rise as they have over the last few years, but will also fall in the future as they did during the Great Recession.

THE GREAT RECESSION

A boom, decades in the making, deteriorated in a matter of months. Millions of people lost their jobs and homes when the housing market started to plummet (i.e., the "bursting" of the housing bubble). From the mid-1990's to the mid-2000's, the average price of housing spiked 124 percent, an "unheeded warning sign," according to University of North Carolina (UNC) Research. The combination of rising home prices, loose lending practices and an increase in subprime mortgages was economically unsustainable, yet the housing bubble continued to grow unabated. Over time, the supply of homes greatly surpassed demand, and finally, the bubble broke in 2008.

Americans faced financial disaster as the value of their homes dropped well below the amount they had borrowed and subprime interest rates spiked. Monthly mortgage payments almost doubled in some parts of the country. In most cases, borrowers were actually better defaulting on their mortgage loans rather than paying more for a home that had dropped precipitously in value.

The crisis hit when numerous foreclosures and defaults crashed the housing market, greatly depreciating the value of deliberately obscure financial securities that were directly tied to subprime mortgages (e.g., mortgage-backed securities). This new reality created a ripple effect throughout the entire global financial system, as banks in the U.S. and around the world began to fail or approach the point of failure. In the end, the U.S. federal government had to intervene quickly to mitigate the damage or systemic failure of our economy could have ensued.



Source: Wikipedia

THE HOUSING MARKET DURING THE GREAT RECESSION

The University of North Carolina has published a thorough treatment of the subprime mortgage crisis and its ripple effects throughout the entire global financial system.

Investors – both foreign and domestic – poured money into the real estate industry and offered home buyers credit without adequate risk management.

THE COMBINATION OF RISING HOME PRICES AND EASY CREDIT WOULD LEAD TO AN INCREASE IN THE NUMBER OF SUBPRIME MORTGAGES, AN UNDERLYING CAUSE OF THE GREAT RECESSION.

Essentially, subprime mortgages are financial instruments with widely varying terms that lenders offer to so-called "risky borrowers." A risky borrower is a consumer with a questionable credit history, questionable income stability and a high debt-to-income ratio.

Moreover, subprime mortgages were popular among home buyers who were purchasing second homes. In fact, lenders specifically targeted these home buyers for subprime mortgages.

Furthermore, subprime mortgages, more often than not, have adjustable interest rates. Subprime lenders offered consumers mortgages that carried low-interest rates for a short time, but after that period, the interest rates spiked considerably. The average subprime mortgage interest rate from 1998 to 2001 was as much as 3.7 percentage points higher than conventional mortgage rates.

POST GREAT RECESSION

The subprime mortgage collapse led to many people losing their homes and economic stagnation. In turn, homebuilding saw a significant decline, resulting in a restricted supply of new homes for a steadily growing population. It took several years for the nation to recover from the Great Recession. However, because of population growth, new jobs and wage growth (demand) and a lack of new homes being built (supply), the nation has seen the real estate environment turn into an appreciating seller's market. More people were now chasing fewer homes, which increased home prices.

Today's housing market owes its stability to the U.S. government's response to this occurrence.

To stimulate economic growth, the Federal Reserve, which is responsible for setting conditions to influence employment and economic growth, slashed the Fed Funds Rate to near-zero. Simply stated, the Fed Funds Rate is the interest rate at which banks borrow from each other. The decision to reduce interest costs allowed people to have more access to capital to reinvest in the economy.

Over the last decade, the net effect of near-zero interest rates has stabilized the U.S. economy by encouraging lending among financial institutions that are systemically critical to the housing market, as reported by UNC's study. The stabilization of the U.S. economy has led to declining unemployment and steady, albeit modest, economic growth; however, a strengthening economy means interest rates have already started to slowly rise.

INTEREST RATES

It is a mistake for home buyers to conflate the Fed Funds Rate with mortgage interest rates. Most importantly, the two interest rates are distinct because the Federal Reserve does not directly mandate any free market interest rates. Instead, the Federal Reserve sets targets to influence the economy, as in its response to the Great Recession. In a dynamic free market, lenders, whether government-backed or privatized, compete for home buyers' business, which drives up or down average monthly interest rates on mortgage loans. Based on corrected housing prices, tighter credit standards and a declining surplus of unsold homes, the average interest rate on 30-year fixed mortgages has remained near historic lows.

Today, supply and demand for housing has stabilized enough that we're now in a heavy buyer's market. As a result, mortgage rates are finally starting to grow to balance with the economy.

INTEREST RATES AND THE HOUSING MARKET

In the real estate business, conventional wisdom says that rising interest rates make buying or selling a home more difficult; decreasing interest rates make buying and selling easier.

For example, if Johnny Home Buyer wants a four percent rate on a 30-year fixed mortgage on a home worth $400,000, his monthly mortgage payment would be $1,900. But if Johnny only qualified for a five percent rate on a 30-year fixed mortgage, his monthly payment would rise to $2,138.

A one percent increase in interest raises Johnny's payment by $238, or roughly 13 percent. What does this mean for buyers and sellers?

RISING INTEREST RATES IMPACT ON BUYERS AND SELLERS

From a home buyer's perspective, as mortgage rates increase, affordability decreases. In the aforementioned, Johnny Home Buyer wants to qualify for a $400,000 mortgage at four percent interest, but at five percent interest, lenders can only offer Johnny a $355,000 loan based on his qualifications. A one percent increase in mortgage interest decreases Johnny's purchasing power by $45,000.

MORTGAGE RATES
AFFORDABILITY

Before the Great Recession, during the peak of the subprime mortgage madness, Johnny Home Buyer would've been able to "qualify" for that $400,000 mortgage he wanted, but to sweeten the deal, a subprime lender would have offered Johnny a two percent adjustable interest rate for the first five years. After five years, however, Johnny is on the hook for at least seven percent interest, maybe more if interest rates spike.

Rising mortgage rates affect sellers as well, though differently. For example, if Jill wants to sell her house for $400,000, she is more than welcome to list her home at that price. Due to rising interest rates, however, potential buyers can only afford Jill's home at $355,000. Indisputably, she can still make a profit on the sale, but only a one percent increase in mortgage rates diminishes the market value of Jill's home by about $45,000; her profit will depend on how well she plays the market.

Essentially, if interest rates were to rise very rapidly, it would slam the brakes on the housing environment. However, rising mortgage interest rates are nothing to fear, and knowledge of the topic will ease housing market participants' fears. It's vital for housing market participants to understand rising mortgage rates, as they impact just about every aspect of buying a home.

PROPERTY VALUE

Rising interest rates do have a very noticeable effect on buyers and sellers. Hypothetical situations prove that property value and housing prices directly correlate to mortgage rates, but what underlies both scenarios is the health of the economy.

If the economy grows fast enough, rising mortgage rates will not have as great an effect on property value and housing prices. For example, if mortgage rates increase one point, monthly payments increase $238; however, a strong economy allows employers to increase salaries enough to help compensate for the rising interest rate. As long as the economy continues to grow, and we continue to see job growth and wage growth, a rise in interest rates should not paralyze the housing market.

REAL ESTATE INVESTMENTS

As mortgage rates rise, the effect on real estate investing can be positive. The market for rental properties will increase because fewer people can qualify for mortgages. That said, rising interest rates reduce prices, so it can sometimes be better to buy during a rising interest rate environment.

Moreover, as interest rates rise, fewer real estate transactions will take place since lending standards will be tighter.

Thus, more people will need rental properties until they can afford a mortgage. A one percent increase in interest for an investor can turn into a windfall of profit in the right housing market through obtaining a greater renter pool and potentially higher rent rates.

IN CONCLUSION: BUY OR SELL?

Today, mortgage rates are staying near four percent, but an increase to five percent in the foreseeable future is completely possible. In fact, it is a given considering there is a stronger economy in 2017.

From a historical standpoint, a five percent mortgage rate is still remarkably low, as seen in data provided by mortgage lender Freddie Mac. The annual average for 30-year fixed mortgage rates has not reached five percent since 2009. At the start of the Great Recession in 2006, the average mortgage rate was 6.41 percent. 10 years earlier in 1996, the average mortgage rate was 7.81 percent, and 10 years earlier than that in 1986, the average mortgage rate was 10.19 percent.

BUY OR SELL?

Buying a home as mortgage interest rates are rising is nothing to fear. Interest rates continue to remain near historic lows, which bodes well for buyers, and today's market reflects some of the cheapest debt a home buyer will be able to attain in the market. A mortgage with a *fixed-rate for the next 30 years* is still considerably cheaper than historical comparisons.

Most importantly, finding the right mortgage depends on receiving the right advice from a seasoned real estate expert who personally owns many properties and has transacted numerous real estate sales for others. Working with an expert enables prospective investors to feel more knowledgeable, confident and secure with their financial decisions.

ABOUT THE AUTHOR

RYAN BOYKIN

In 2008, Ryan Boykin co-founded DP Assets, LLC, which later purchased and now operates Atlas Real Estate Group (Atlas). DP Assets was created to capitalize on the nation-wide real estate crash and foreclosure epidemic that began in 2008. DP Assets and Atlas Real Estate Group currently owns a portfolio of real estate across four states comprised of apartment communities, industrial sites, office, retail and single-family assets. In addition to these holdings, Atlas Real Estate Group has two other divisions: a full-service real estate brokerage with 20 real estate agents and a property management company with over 1,400 units of residential real estate under management.

Over the past eight years, DP Assets and Atlas Real Estate Group have directly purchased or sold over $750mm real estate deals for their institutional and individual investment funds. Of that, more than $500mm has been directly invested into the Denver Metro real estate market on behalf of Atlas and its investment partners.

Prior to founding DP Assets and Atlas Real Estate Group, Boykin co-founded US Capital in 2005, a private equity holding company based in Denver, CO. US Capital successfully invested into numerous venture capital backed companies that went on to have successful exits via IPO and merger/acquisition. In June 2008, US Capital sold its portfolio and assets to Northport Investments, a Chicago based private equity firm.

Boykin is an alumnus of the University of Denver and was born and raised in Denver, CO. He is fluent in Spanish and conversational in Chinese. He is a current member of the 2016 class of Leadership Denver. He is a former member of the Board of Trustees for Escuela de Guadalupe, a dual language elementary and middle school focused on academic excellence for financially distressed youth in Denver. He is a former board member for MicroVentures Private Equity located in Boulder and Solar Trade Inc. based in Massachusetts.

Boykin is dedicated to giving back to society. His passion for community wellbeing is only rivaled by his passion for building a better world through business. His mantra, “good for you, good for me, good for everything,” is evident in his steadfast commitment to creating a vibrant, connected and equitable community. His volunteerism has touched numerous local and national nonprofits.

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