Do higher bond and mortgage rates pose a threat to the recovery of the U.S. housing market?

The U.S. housing market is expanding. Home sales are up, housing starts are returning to more acceptable levels, and prices have risen by 13.5% since the trough of 2012. At first glance, the recent surge in bond and mortgage interest rates could threaten this recovery. But as long as overall economic conditions improve and credit conditions ease, the net effect should not jeopardize the housing market, even if interest rates rise more than anticipated.

THE RECOVERY

It was a long time coming, but the recovery in the U.S. housing market finally seems well underway. While the recession that hit the United States in 2008 and 2009 lasted six quarters, the one that specifically affected the housing sector lasted much longer. The real estate bubble burst in 2005, and the recovery did not start to really take shape until 2010 or 2011, according to the indicators. Since hitting their low point, sales of new single-family homes have skyrocketed by 76.3%, while sales of existing homes have escalated by 50.1% (graph 1). The levels that have been reached lately are still quite modest compared to the peak of the mid-point of the 2000s decade. Meanwhile, housing starts are also perking up. They have nearly doubled since their trough of 2009 and are getting ever closer to normal levels. Still, the figure reached in May 2013 represents a mere 40% of that of January 2006, reflecting an atypical recovery (graph 2). The rally in housing starts provides evidence of rising confidence among homebuilders; the NAHB index suggests that further growth in the new homes market is around the corner (graph 3 on page 2).

The housing market’s collapse has also severely tested home values. The S&P/Case-Shiller index of existing home prices in 20 metropolitan areas of the United States plunged by 33.8% from the peak of April 2006 to the low of January 2012. So the bear market lasted 69 months! Some regions were harder hit by the burst of the bubble and, as
The recovery in the housing market has clearly positive consequences on the U.S. economy. After constituting a drain for five years, and making a neutral contribution in 2011, residential investment finally made a positive contribution to U.S. real GDP growth in 2012. Higher property prices also have positive effects on growth thanks to the improvement in the net worth of households. This produces a wealth effect that benefits confidence and consumption.

**FACTORS BEHIND THE GROWTH**

Apart from the upward trend that normally emerges once the market has stabilized, several factors have promoted the recovery of the housing market:

- The drop and the weakness of home prices.
- Low mortgage rates.
- Improvement in the economy and in the job market.
- Demographics and the formation of households.
- Easing of credit conditions.

The first three factors listed above certainly played the largest role in the market’s cyclical recovery. Lower home prices and the decline in mortgage rates to an historic low have made the real estate market more accessible. At the peak of the bubble, the National Association of Realtors affordability index showed a very tough situation. Now that the market has stabilized, that situation has completely reversed itself and, according to the index, houses have never been so affordable for a household with median income as they were last winter (graph 6). Since 2011, monthly mortgage payments (not including taxes and other ownership costs) have fallen below the median rent (graph 7 on page 3)! The improvement in affordability took a while to bear fruit and to convince households to start buying properties again. Even when the recession was...
over, Americans continued to be affected by the lack of improvement in the labour market, flagging confidence and ongoing trouble in the mortgage market. As those clouds dissipated, the positive effects of greater affordability became more evident.

Some barriers are still in place, however. With respect to the tightening of credit conditions that took place between 2007 and 2010, financial institutions have not relaxed their requirements much, although some easing is underway, especially for borrowers with a good credit record (graph 8). However, we must stress the fact that the mortgage credit market is still far from being restored to normal. Nearly 20% of mortgage loans are still “underwater”; that is, they have a higher balance owing than the value of the homes attached to them. Over 7% of mortgage loans are overdue. Private-label mortgage-backed securities outstanding are only 40% of what they were in 2007, and new issues are practically non-existent. Faced with these problems, the U.S. federal government and its major mortgage agencies have had to assume a leading role in financing new mortgages and providing access to better refinancing conditions.

**THE RECENT SURGE IN INTEREST RATES**

Along with the decline in home prices, the drop and the subsequent low level of interest rates are the source of improvement in the accessibility of the real estate market. In the summer of 2006, the average mortgage interest rate was 6.76%; by December 2012, it had fallen to 3.28%. This movement reflects the decline in yields on the U.S. bond market. From its cyclical peak to its low of last year, the yield of the federal 10-year bond tumbled from 5.23% to 1.47%, and that of the 30-year bond from 5.29% to 2.53%. The financial crisis, the recession and the slow pace of the economic recovery, the weakness of inflationary pressures, the safe haven status of the U.S. bond market and the very expansionist policy of the Federal Reserve (Fed) are the main factors behind the plunge in interest rates in the fixed-income market.

This downward trend in yields has now come to a halt. Somewhat more robust economic growth and abating financial pressures from the European crisis enabled interest rates to stabilize and to begin creeping up in the first few months of 2013. Some new economic stumbling blocks drove them down again in the early spring, but the prospect of the Fed moderating its very expansionist monetary policy sparked a surge in yields starting at the beginning of May. Consequently, the interest rate on 30-year fixed mortgages climbed from 3.59% at the very start of May to 4.68% at the beginning of July, a 2-year peak (graph 9).

**CONSEQUENCES OF HIGHER INTEREST RATES**

There is a risk that higher interest rates could prematurely arrest the recovery of the real estate market, but it seems unlikely that this will happen. Due to tighter credit conditions and the weakness in the supply of loans from financial institutions during the post-recession period,
mortgage loan applications for a home purchase have not reacted much to low interest rates (graphs 10 and 11). On the other hand, refinancing applications do closely follow trends in mortgage interest rates (graphs 12 and 13). We note a very strong correlation (negative) between interest rate trends and refinancing applications, including the recent episode of rising interest rates which caused refinancing applications to fall to their lowest level since the summer of 2011. Therefore, if interest rates continue to rise, this will likely mainly affect refinancing, but not overall demand for homes to any great degree.

Obviously, the consequences of higher interest rates depend on the speed and the magnitude of their increase. The recent movement was quite abrupt, with an over 100 basis point increase in 30-year mortgage rates in the space of two months or so. Our scenario for bond yields assumes a lull in the upcoming quarters, in keeping with the statements by Fed officials who are attempting to moderate the financial markets’ expectations of a hasty halt to the expansionist monetary policy. The Fed will probably slow its bond purchases (including mortgage bonds guaranteed by the federal agencies) starting in the fall of 2013, but the pace should be gradual. The recent spike in market rates essentially looks like an anticipation of that decision, which the Fed has not even taken yet. According to a study by the International Monetary Fund, the Fed’s bond purchases have triggered a cumulative drop of between 100 and 200 basis points in 10-year bond yields1. Even though the Fed will probably keep buying bonds for another year (and there is not even any question of it subsequently relinquishing the bonds it has acquired), the markets have already reacted to the future end of the quantitative program. Yield trends should therefore be more moderate after this. Our basis scenario calls for a further increase of just 20 basis points between now and the end of 20142. The same movement is forecast for the 30-year yield (graph 14 on page 5).


The bulk of increases in bond yields and mortgage rates thus seems to be behind us. This trend, combined with an ongoing upturn in home prices, should reduce affordability as calculated by the index produced by the National Association of Realtors. That decline, severe in the very short term, will stabilize thereafter and, in general, the affordability index suggests that higher interest rates will not do too much damage to the accessibility of the housing market. Even a far more pronounced and sustained increase in bond interest rates would not be too serious. A more extreme scenario in which bond and mortgage rates increase by 25 basis points per quarter by the end of 2014 would only reduce the affordability rate to its average of the past three decades (graph 15). Such a scenario implies that at the end of next year, the yield of the 10-year federal bond would be 4.00%, that of the 30-year bond 5.00%, and the rate on 30-year mortgages would be 6.00% i.e. higher than where they stood in the spring of 2011, before the debt ceiling crisis and the announcement of additional easing measures by the Fed. Such an increase in rates would not be desirable nor expected, but neither would it be disastrous.

CONCLUSION
It would appear, then, that the U.S. housing market is capable of withstanding an increase in interest rates, if it reflects improvement in the economy. If the rates go up, but the economy and the job market start to falter again, home sales will obviously be hard hit. However, a new economic slowdown would trigger a reaction from both the Fed and investors; the rise in interest rates would quickly be aborted and replaced with another downward trend. So, as long as the economy accelerates and mortgage credit conditions ease, the U.S. housing market will continue its return to a more normal level of activity which, in turn, will put households and the economy in general in a better position. The vicious circle that did so much damage during the crisis may now become, to some extent, an engine of growth.

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