An economic shock just hit the housing market
Lancer Lambert - Fortune

When the pandemic struck two years ago, the Federal Reserve used nearly every lever at its disposal to combat the COVID-19 recession. That included cutting its benchmark interest rate to zero. Lower interest rates incentivized businesses to invest and borrow cheap money. It also encouraged buyers—enticed by record low mortgage rates—to jump into the housing market.

That's all behind us now. The Federal Reserve has moved its focus from helping the economy recover to getting inflation under control.

Last week, the central bank raised rates for the first time since 2018. In anticipation of the hike, the average 30-year fixed mortgage rate spiked from 3.11% in December to 4.16% as of last week, according to Freddie Mac.

That upward swing isn't over yet: Bankrate reports that as of Wednesday, the average 30-year fixed mortgage rate is 4.52%. (We won't get the official number from Freddie Mac until Friday).

The real estate industry knew higher mortgage rates were coming—but they didn't expect it to be this high. Indeed, heading into the year, Fannie Mae predicted that the 30-year fixed mortgage rate would average 3.3% in 2022 and 3.5% in 2023.

Industry insiders tell Fortune this swift move up in mortgage rates amounts to an economic shock. After all, just look at what it's doing to mortgage payments. A borrower who took on a $500,000 mortgage at a 3.11% rate would get a monthly mortgage payment of $2,138. At a 4.16% rate, that jumps to $2,433. If rates this week do cross 4.5%, that payment soars to $2,533.

Back in January, Ali Wolf, chief economist at Zonda, a housing market research firm, laid out two different scenarios for Fortune.

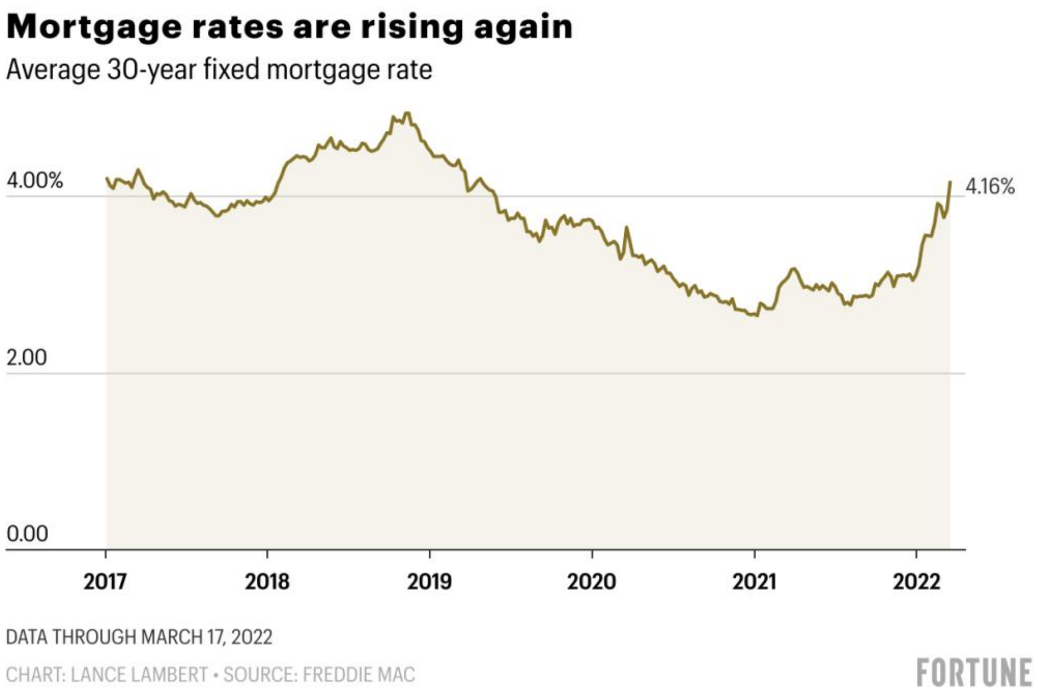
"If rates approach 4% before the end of the year, there will be a notable downshift in housing demand. If mortgage interest rates gradually rise throughout the year allowing home sellers to price their homes accordingly, then the shock to the system will be less noticeable."

Of course, what we're seeing now is anything but gradual.
Now that rates are spiking, Wolf has adjusted her view a bit: She thinks a "downshift" in buyer demand will take time to get going. Why? As rates have climbed, Wolf is seeing more home shoppers rush into the housing market in hopes of locking in rates before they go even higher.

Simply put: In the short-term, rates are putting upward pressure on an already red-hot housing market.

"Rising mortgage rates are having a counter-intuitive effect on the housing market. Home shoppers are actually sprung into action in an attempt to buy a home before

mortgage rates rise any higher," Wolf tells Fortune. "Some home shoppers are nervous that if they don't buy today, they may never be able to given affordability."



That uptick in buyer urgency should be a short-term boost to the market. However, once it passes, the reality of higher rates should put downward pressure on the housing market.

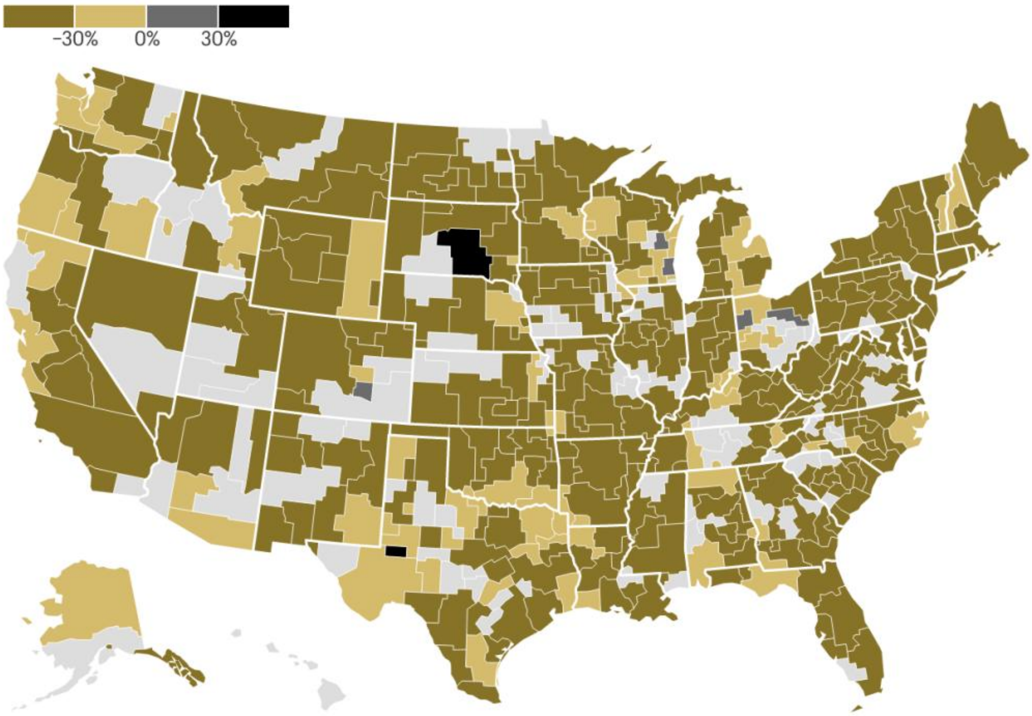
Not only do higher rates mean buyers' monthly mortgage payments rise, it also will result in some buyers (who must meet banks' strict debt-to-income ratios) losing their mortgage eligibility. Fewer buyers should result in a deceleration of U.S. home price growth—which is up 18.8% over the past 12 months.

That said, don't expect home prices to fall: Not a single major real estate firm is predicting prices will fall over the coming 12 months.

The reason? Inventory plummeted during the pandemic (see the chart below) and there simply aren't enough homes for sale to match demand from buyers. Even if some buyers back off in the face of higher rates, we'd still have an inventory crisis, says Nik Shah, CEO of Home.LLC, a startup that provides down payment assistance to homebuyers in return for a share of any profits.

Shah tells Fortune that his forecasting shows home prices continuing to rise "in 2022 and beyond."

How housing inventory has shifted during the pandemic



CHANGE IN INVENTORY LEVELS BETWEEN FEB. 2020 AND FEB. 2022. MARKETS SHADED LIGHT GRAY INDICATES THERE IS INSUFFICIENT DATA.

MAP: LANCE LAMBERT • SOURCE: ZILLOW

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If rising mortgage rates do cause the housing market to cool down a bit, that'd be welcomed by many housing economists. One of the industry's fears is that home price growth remains at an unsustainable level and leads to an overheated market. After all, home price growth can't outpace income growth forever. At its latest reading, year-over-year home price growth was still increasing six times greater the rate of incomes.

"Rising mortgage rates could eventually be good for housing by trying to bring the market back to a healthy place, but there will likely be some inequality collateral damage along the way," Wolf told Fortune.