Effect of Renewing Mortgages and the Residential Real Estate Market

By: Joe the Investor

The scenario as it stands today looks like this. Interest rates were lowered after 2008 which made servicing mortgages cheaper. This in turn drove up the price of real estate since it allowed more buyers to enter the market. The buyers in particular were not able to enter the real estate market in the past due to affordability constraints. This influx of buyers increased demand and drove up the cost of residential real estate. Since maintaining debt was cheaper, this offset the higher cost of purchasing a home. Now that interest rates are rising, the cost of servicing the debt has risen as well. Add to this the rising cost of most other goods (inflation), and there is a cash flow squeeze among homeowners with a lot of debt, few asset or cash resources, or income that is too low to absorb large increases in cash flow outlays.

What happens next? If the homeowners cannot afford to keep their homes, they will either have to cut expenses somewhere in their budget, or sell the house to relieve themselves of the debt. The homeowners then become renters and drive up the demand for rented spaces, which is what has been transpiring over the last year. The selling of the houses increases supply, while demand from new buyers decreases due to the perception that prices will go lower and there are better deals to be had.

Beyond this, another phenomenon may occur. People who are not getting new mortgages or don't have variable mortgages would be insulated from interest rate increases due to their budgets being static, at least for now. There will be a time however, when mortgages will have to be renewed. The interest rates present at that time can be much higher compared to their last renewal, which would cause a jump in the interest costs in owning debt. Now the homeowners with mortgage renewals are facing the same dilemma as new homeowners are today. They will either have to find additional resources to pay additional interest costs, or sell their properties. The specter of high inflation aggravates this problem, because it is also adding to future costs. If income increases to match these extra costs, the homeowner may not have to make this choice, but many people working for a living are seeing pay raises of 8% per year?

Should buyers not materialize to counteract a steady wave of sellers, house prices may continue to fall. Contrary to popular belief, the price of anything is determined by a buyer and seller agreeing on a price. It does not depend on what the item costs, historical prices or any value based on production. If nobody wants an item, it is effectively worthless. If many people want something and it cannot be found, the price will explode.

What is the key takeaway message? The effect of higher interest rates will continue to linger in the real estate market for the next few years unless interest rates go back down, or some other variable changes in the supply-demand dynamic which makes housing more affordable. This variable can be much lower inflation or some government interference in the housing market which would not fix the problem but distort it. Note that if interest rates stay the same and do not rise any further, this cost overhang from more expensive debt will persist.