AMSA

European and American Housing Markets' Reactions to Increasing Interest Rates

Real-Estate

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Introduction

Various asset classes react distinctly to changes in interest rates. While higher interest rates lead to lower bond prices as the principal is eroded, the effect on equity may not be as direct potentially leading investors to pull their capital from the stock market to invest it in the now more profitable bonds, and alternative investments, which are highly dependent on leverage capacity, may show reduced activity given higher interest payment on debt.

So far, the relationship between interest rates and housing market has been quite straightforward; when rates go up, borrowing money is more expensive, and demand for housing drops. This in turn slows price appreciation and housing takes longer to sell, leading to higher levels of inventory for sellers. This report will highlight how the European and American real-estate market may currently challenge this assumption.

European Real Estate Investment Outlook

The European Union is certainly no stranger in dealing with economic hardships as the repercussions of the 2008 financial crisis followed by the 2011 eurozone crisis are still vividly present. However, the biggest challenge may yet await as the Covid epidemic resulted in extensive fiscal and monetary expansion which is now met by steep inflation rates accelerated by a war on its borders. Departing from a near zero interest rate regime seems inevitable, and this essay studies the potential consequences this will have for the European real estate and property market focusing on the good, the bad, and the ugly.

Currently, surging inflation has caused interest rate risk in Europe's real estate financing market to be on its highest level since the global financial crisis.

As seen on the table from Statista below, mortgage rates in Europe have universally increased over the past year. As mortgage rates rise, real estate demand drops as debt becomes more expensive and negatively impact asset prices.

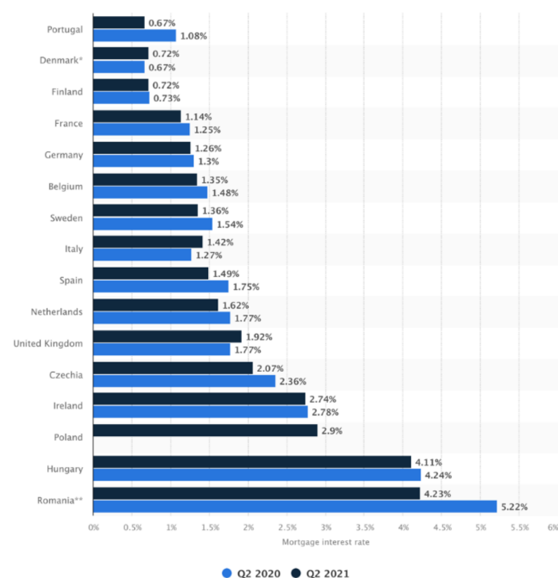

Figure 1: European Mortgage Rates

However, when mixed with high levels of inflation, real estate prices may continue to climb benefitting property owners yet further reducing buyer appetite.

As inflation reduces the purchasing power of a unit of currency, high inflation levels can severely disorder an economy's pricing system leading firms and individuals to make less than optimal saving, spending, and

investment decisions. Moreover, economic agents will take measures to shield themselves from the negative effects taking resources from more productive uses.

Previous data suggests that real estate serves as a strong inflation hedge. Research from Wharton School of Economics found that REIT dividend income outperformed inflation in 306 of the 404 months, preserving purchasing power throughout this period.

From an economic point of view, real estate ownership during inflationary periods nets several advantages. First, property prices will keep pace with the increase in price level combatting the value eroding nature of inflation. This effect is potentially aided by a decrease in real estate development projects due to greater labor, material, and machinery costs as these mechanisms further depress the supply of new housing and therefore make existing property more valuable.

Furthermore, higher inflation also pushes rents up and with slowing property development, real estate owners again benefit. However, other players in the real estate market will have more mixed fortunes. The head of Investec Real Estate, Mark Bladon, predicts that rising interest rates will lead to “interest coverage ratios in investment will come under stress” meaning those investors that have taken up floating interest rate debt will find it more difficult to serve their obligations.

Walter Boettcher, head of research and economics at Colliers sees the rate rises not a source of concern as those equity investors that hold leverage, appear to be not overleveraged, hence they will not come under distress. However, he has a more varied outlook for the secondary market as increasingly commanding ESG criterion will put additional pressure on those tht refinance their loans and the dynamic between primary and secondary assets will be important to observe.

The iShares European Property Yield ETF shown below, shows a slight negative development of yields since the start of the year with high volatility since the start of the Covid epidemic.

Figure 2: iShares European Property Yield ETF

In summary, given the volatile global market, owning European prime real estate that ensure consistent streams of income may provide a profitable investment allocation choice. It serves well in preventing value eroding mechanisms stemming from inflation and holds diversification benefits. However, investors need to be aware that real estate investment exposes them to several risk sources such as government intervention, real estate bubbles, and a potential reversal to low inflation that mixed with high interest rates make real estate investment less attractive. Moreover, being overleveraged could be a real cause of concern and should be monitored closely.

American Real Estate Investment Outlook

The American market has been characterized by surging interest rates. The 30-years mortgage rate has surged from 3.3% to 4.9% since the beginning of the year, with an aim to refrain the housing market in its recent skyrocketing increases (Amstrong and Whu, 2022). The first reactions where a rush towards real-estate investments to still benefit from reasonable rates, but this rush has stopped because of the unprecedented mortgage rate increases. The Mortgage Bankers Association notably observed 10 percent year-over-year less mortgage application on the week ending March 25, the second consecutive week of decline. The monthly mortgage payment on the medial home sale was above 23% higher than a year prior (Mazing, 2022).

Figure 3: 30 Year Fixed Mortgage Average in the US.

Certain actors of this market, notably the Bank of International Settlements, warned that rises in interest rates could create constraining burdens on existing debt holders, and cause downfalls in house prices (Editorial Board, 2022).

Nevertheless, the reverse phenomenon is surprisingly observed. Housing prices continue to increase, even though monthly mortgage payments are at high levels. This is notably observed on the general Housing Price Index.

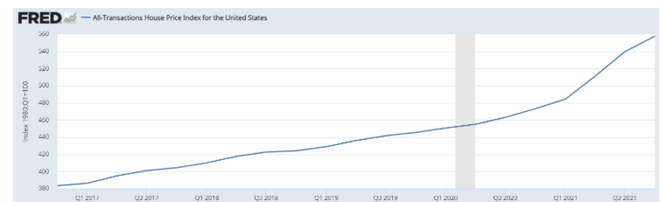

Figure 4: All-Transactions House Price Index

This could be explained by other macroeconomic factors, principally supply. In fact, there is an historically low supply of new houses, due to several factors such as low inventories, many owners multiplying holdings of homes as rental investments – thereby freezing the market – and many people that are reluctant to sell their house by fear of not finding their next home. (Badge and Quoctrung, 2022). High rates may also deter some that were ready to sell, as refinancing will be particularly expensive.

In addition, there is a lack of alternative for home ownership, as rents are also experiencing sharp rises, and that buying a home can be a interesting shield against inflation, as mortgage rate increases remain below inflation levels (which approaches 8%).

The main question now is whether there is an expected deceleration of intensity in the real-estate market? As mentioned above, it is expected that the boom in buyers is a short-term reaction to market conditions, and that high rates will act, as expected, as pressures on the market (Lambert, 2022). This will be caused by both higher mortgage payments rises, thereby discouraging certain buyers, but also by simply making potential past buyers ineligible to loans. An important note though, is that

lower growth in price is expected, not decreasing prices. This appears to be a consensus on the markets. The lack of home supply just creates conditions of logical housing price increases (Lambert, 2022).

There lies an important danger. Home price growth cannot consistently outgrow income growth, not in a sustainable economy. The pace of the former compared to the latter was around 6 times higher. An overheated market could create a bubble effect and have a destructive effect on home values, and on the economy in general (Lambert, 2022).

In conclusion, entering the American real-estate market now is as logical as it is risky. On the one hand, while mortgage rates are high, resulting in considerable costs of financing, investing now (after the short-term rush of increase announces) might be suboptimal for investors and waiting for potentially decreasing rates later this year or next year could be more viable. On the other hand, home prices increase, and are expected to continue to do, henceforth, postponing investments might just represent opportunity costs, especially considering the inflation hedging properties of real estate investments. Importantly, and now maybe more than ever, investors should keep in mind a potentially disrupting event resulting in a general crash of the real-estate market, as this market consistently pushes the boundary of what sustainable and socially viable market represents.

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