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Rising interest rates, slower price growth create challenge for buyers

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Think housing prices are too high? Tempted to delay buying a home until they decline a bit?

Then here's a scenario for you (and sellers, too) to consider. It's based on numbers from a national housing economics expert, Michael Sklarz. He says it's indeed possible that home prices here could take a dip, and he'll tell you why.

Let's say that earlier this year you fancied a house costing $252,000. That's the current median price of a single-family home in the Seattle-Bellevue-Everett metropolitan area. But that seemed too steep a price, so although you could get a mortgage with a bargain-basement 5 percent interest rate, you decided to wait for home prices to fall.

What could make prices decline?

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Rising mortgage interest rates, says Sklarz, the chief valuation officer for Fidelity National Information Solutions. He calculates that every 1 percent rise in mortgage rates — which have jumped a point in the last month — dampens prices by 4 percent.

In his scenario — only an example, not reality — interest rates climb to 8 percent.

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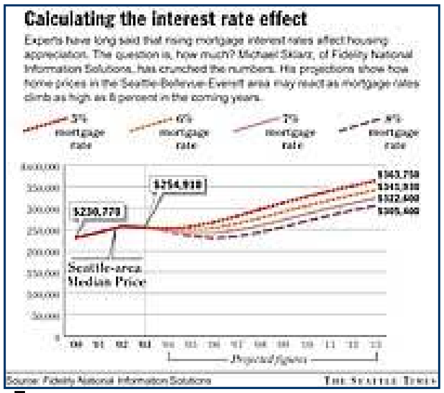
Meantime, that house you fancied has felt the effects of that rate hike and is now $245,000, so you buy it.

In long run, you pay more

Here's the result: You pay some $7,000 less for your home. But the difference between a 5 percent and an 8 percent mortgage has boosted your monthly house payment by $400 a month, to $1,600.



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That demonstrates the appreciation-dampening power of interest rates, which have been much on the minds of housing-industry watchers as they've begun to climb.

Until the end of July, the interest rate on 30-year, fixed-rate mortgages had been below 6 percent for six months, bottoming out in early June at 5.21 percent, according to mortgage backer Freddie Mac. Rates for 15-year and adjustable-rate loans were even lower.

That rate dip led to two things. One was a huge boom in refinances. The other was roaring home sales. Both have made housing the shining star in an otherwise lackluster national economy.

Renters suddenly could afford to become buyers and have done so in record numbers. Indeed, the National Association of Realtors calculated that first-timers accounted for 40 percent of this year's sales. Their purchases started a chain of move-up buying.

Locally, July's sales of single-family houses and condominiums were up 39 percent from the previous July, the Northwest Multiple Listing Service reported.

King and Snohomish counties did even better: Sales were up 45 percent. Pierce County, meanwhile, showed a 21 percent sales increase.

Then August rolled around, and mortgage rates hit 6 percent. They've been bobbling at about 6.3 percent ever since.

It's anyone's guess

That 1 percent rise has people wondering whether they'll go higher (there's no consensus among economists they will) and, if so, what that effect will be. Short-term, it's clear.

"This will be our best August," says J. Lennox Scott, president of John L. Scott. He notes that rising rates are the catalyst that propels some indecisive buyers to make the big move.

"It creates commitment," Scott observes. "People want to lock in before they go up further."

However, in the long-term, Scott says, every 1 percent increase in mortgage rates translates to 4 to 7 percent fewer home sales. And that can lock first-timers out.

"But we also need to put things in perspective. When rates were in the 4s, they were unbelievable. In the 5s, they were phenomenal. In the 6s they're fantastic."

Indeed, on a historical basis, today's 6 percent interest rates are about where they were in 2002 — and considerably below most of the last two decades, when they ranged from 8 to almost 17 percent.

They began dropping in 2000 in response to the recession and continued dropping as the government tweaked the economy in an effort to end its sluggishness.

They're going up now in part because of investors' reactions to the Federal Reserve's decision not to buy long-term securities. Those financial instruments, like 10-year Treasury bond notes, affect mortgage rates.

Generally, rising interest rates are an indication that the economy is improving.

However, the Seattle area isn't out of the woods yet, says economist Dick Conway, who, along with his business partner Doug Pederson, prepares a quarterly housing-trend analysis called the Windermere Index.

Housing demand slows

In their just-released index, the economists noted that local employment continued to decline in the second quarter, resulting in the highest unemployment rate — 7.1 percent - — in a decade. Population growth and the demand for new housing both slowed.

(July's 7.5 percent unemployment rate, coupled with Boeing's announcement of an additional 490 job cuts, continued the pattern.)

Says Conway: "If mortgage rates edge up much more and at the same time the economy is still struggling, this could create problems in the housing market."

As it is, after increasing 6 percent last year, local home prices will go up only 2 percent this year and just 1 percent next year, Conway forecasts. Compare this to the 14 percent annual price appreciation King County saw in the late 1990s.

Does this mean there's a housing bubble and it's bursting? Sklarz, the Fidelity National Information Solutions valuation officer, doubts it.

A price bubble, Sklarz explains, is "an unsustainable rise in prices that eventually bursts." These price rises occur when appreciation greatly exceeds inflation, and people decide that the thing that's appreciating — stocks, for example — is a good place to put their money.

This speculation of ever-greater appreciation drives up demand until prices reach unsustainable levels. Then the bubble bursts and prices retreat.

However, it's harder to have that kind of bubble-producing speculation in residential real estate, Sklarz observes. Lender appraisal requirements are one reason; banks won't lend more than properties are worth. Another reason is the "stickiness" of real estate. Investors can easily dump stocks; houses less so, particularly if the owners need them as a place to live.

In the face of falling housing prices, rather than take a loss a seller might decide to wait it out until the market rebounds, Sklarz observes.

Out-of-area bubbles

This is not to say that areas can't have bubbles. They've occurred in various California cities as well as Honolulu, where Sklarz lives.

Rather than experiencing a true real-estate bubble burst, the Seattle area is probably in a period where prices stair-step sideways for a while, rather than going up or down.

Sklarz says that's typical of West Coast housing markets. They get caught in a supply-and-demand squeeze when the local economy heats up or job growth occurs but not enough housing can be built to meet the increased demand.

After studying more than 300 housing markets, Sklarz says, "Seattle fits well within the supply-constraint coastal type of market. These tend to get much more emotional. People say, 'the market is taking off, and I'd better buy right now.' You get this whole hysterical thing that doesn't happen in a Cincinnati or a Kansas City."

They're among the Midwestern cities that have room to grow if their economies require it.

Already Seattle has experienced a bit of this correction, Lennox Scott, the president of John L. Scott, points out.

It happened beginning in 2000 when luxury-home prices peaked, then stalled. "Now they've adjusted, and we have a new basis, and they'll go up from here," he says.

Sklarz is among those who are forecasting interest rates to stay in the 6 to 6.5 percent range into next year. But even if they don't, that doesn't necessarily mean there will be a severe impact on housing sales.

"The main drivers of home prices are affordability, which incorporates interest rates, and job growth," he notes.

If the economy picks up going into a presidential election year and people have more money in their wallets, that will offset mortgage rates and keep home purchasing attractive.

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