SMALL BUSINESS

Listing Price Hikes, Rising Rates And Impending Inflation: How New Factors In The Housing Market Could Impact Investors

Zain Jaffer Forbes Councils Member
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Jun 15, 2022, 07:45am EDT

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Months ago, an ongoing price hike on existing and new American homes was supported by three economic factors: the increasingly low supply, the strong demographic demand and the interest rates that were historically low and dropping. At the peak of that hike, homeowners were sitting on more equity than ever, while the purchase equation got further out of reach for investors and prospective buyers alike.

Now, with a recent spike in interest rates and rapid inflation, the problem of affordability is taking center stage. Following is a look at the new factors to consider in the housing outlook and how it all could impact the market and investors moving forward.

10-Year Treasury Yield Spike

The 10-year treasury yields between March 2021 and March 2022 show an increase of 100 basis points. In the world of investing, rising yield typically indicates an appetite for higher-risk, higher-reward investments across other asset classes, but in today's context, it also shows an aggressive approach by the central bank to drive down inflation.

When experts tracked the average correlation between treasury yields and mortgage rates, they determined a typical spread of roughly 170 basis points. With that math, the current 30-year mortgage rate would expectedly be around 3.85%, considering the current 2.15% treasury yield, but most rates are currently above 4%. In effect, borrowers are experiencing a higher-than-normal risk premium, which could be due to the outlook for inflation and expected further action from the Federal Reserve.

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Naturally, numbers like this will make investors hold their breath. Rising rates are generally a net negative for the housing market, as they decrease the ability to borrow and result in less deal flow. Still, real estate remains one of the most stable asset classes, which is why I think it's important to treat it as a long-term growth strategy. Always remember to look back to earlier trends when trying to plan ahead and that adjustments to your portfolio need not be extreme—after all, the market conditions you're responding to are temporary.

Downstream Effects

The volatility involved in food and energy prices complicates inflation calculations. But the notable uptick in the cost of both commodities have immediate effects. With a few representative calculations, the investment banking company UBS expects the recent price of gasoline to increase a monthly fuel budget by $65. In addition, the U.S. Department of Agriculture has estimated a 3.5% food inflation: another increased line item on the average budget.

Naturally, investors hold their breath in the face of rising interest rates. Decreasing the ability to borrow and resulting in less deal flow, rising rates are generally a net negative for the housing market as a whole.

In situations like this, I like to try shifting my focus from the market as a whole to specific sectors. While the combination of higher interest rates and higher mortgage rates will likely depress the housing market as buyers opt for smaller, more affordable homes, it's important to consider how these constraints on buyers may affect renters. If fewer prospective homeowners are willing to take on mortgages, we may see an increase in people seeking rental properties. If you haven't paid as much attention to the rental market—including short-term rentals—now may be the time to do so.

Industry Changes

Equally in need of consideration is how the rising interest rates will change the sector. The numbers point strongly toward the red, but I think the real outlook is slightly more positive. Almost 40% of homes in the U.S. are not mortgaged. Those homeowners have benefitted from an increase in home equity enough to empower a strong purchase, especially if they're moving into a more affordable market.

While rising rates compared to general income figures paint a dull picture, many people in the market segments in which prices are ballooning have a large amount of their wealth sourced from equity rather than income. That paints a slightly more optimistic picture of

purchasing power than does a simple analysis using monthly income figures only.

UBS showed how rising mortgage rates could affect monthly mortgage payments across market segments. If mortgage rate increases are limited to 50 basis points from where they currently stand, the effect could still be manageable—assuming housing prices remain roughly the same and limit their climb. And on a brighter note, a number of markets that are seeing lower home prices than other market segments still have median incomes that are comparable to other markets, making the purchase equation there even more attractive and boding well for short-to-long-term affordability in those areas.

While investors should keep a close eye on sudden changes (like inflation), don't forget the bigger picture. Anyone who is invested in the real estate market's long-term potential will need to consider how attempts to curb climate change, for instance, will affect some of the market's basic principles and practices. Failing to keep up with new regulations, such as requirements to decarbonize properties, can have significant costs, while getting ahead of these changes by investing in properties that use green technologies can have significant returns. This is just one example for keeping abreast of changes in the market; I've found the most effective strategy is maintaining a mindset (and a portfolio) that is as attentive to what's happening now as it is to what's going to happen in years to come.

It is the magic of the market that the invisible checks and balances work together, with some luck, toward market strength and a general increase in access and affordability. And energy in the economic sense is neither created nor destroyed; much of the current yield in the housing market has moved to the rental space,

which has become a viable pathway to earn a side income. With a better understanding of the factors at play and some emergency maneuvers, we can hope to return to market equilibrium in the next phase of recovery.

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