Good Intentions Go Awry: Record Low Mortgage Rates Caused This Housing Impasse

If the road to hell is paved with good intentions, then the road to economic purgatory is paved with, well, good intentions and easy money. We are seeing a scenario of unintended consequences play out today via the distorted supply-demand imbalance in the U.S. housing market that shows no sign of letting up and which could persist for quite a while longer. This distortion is mostly the result of COVID-era policy actions and responses to them that juiced the housing market in 2020-2021 but are now bogging it down, as potential sellers cling to their homes and super cheap mortgages while unyielding home prices remain out of reach for most aspiring home buyers given the spike in mortgage rates. Supply-demand imbalances in almost any free market are resolved via price adjustments, but that is not happening with home prices, as there is little incentive for prospective sellers to reduce asking prices and surrender their cheap mortgages in this sputtering market. They would rather stay put until "normal conditions" return — though there was nothing normal about the COVID-era housing market. Consequently, existing-home sale transactions have slowed dramatically this year.

The Federal Reserve's response during the COVID-19 pandemic was multifaceted but featured an all-out effort to lower interest rates to all-time lows via a reduction in its targeted Fed Funds rate to 25 bps from March 2020 through March 2022, as well as aggressive open-market purchases of Treasury and mortgage-backed securities that caused the size of its balance sheet to double within 18 months while pushing the nominal 10-year Treasury note yield towards 0.5% at its nadir in August 2020. Other market rates of interest followed along, as yields on BBB-rated corporate bonds approached 3.0%, and a 30-year fixed-rate home mortgage dipped below 3.0% in that time frame. For borrowers it was nirvana, but for savers it was hellish. Near-zero rates of interest combined with torrents of financial liquidity provided during the COVID period unleashed all sorts of speculative (often excessive) investment activity, including rampant day-trading in stocks, bubbly tech company valuations, NFTs (remember them?), cryptocurrencies and, yes, housing.

Sales of existing homes hit 6.1 million units in 2021,[1] the largest annual total since the peak of the housing bubble in 2005-2006, while average home prices nationally soared 30% cumulatively in 2020-2021.[2] Record low mortgage rates were supposed to make homes more affordable for buyers but instead drove up home prices to record highs and laid the groundwork for the current environment.

The unintended consequences of record-low mortgage rates on the housing market are now apparent just two years removed from the COVID-era boom in mortgage refinancing, relocations and second-home purchases. There were $5.8 trillion of first-lien home refinance originations in 2020-2021, according to Freddie Mac,[3] which would equate to some 21 million homeowners refinancing their home mortgages at rates in the 3.0% range using reasonable assumptions. Freddie Mac estimated that homeowners who refinanced their mortgages in 2021 saved approximately $2,700 on average in annual home mortgage payments — and much more (up to $3,900) for homeowners in more expensive housing regions of the country,[4] a significant source of savings for Americans who refinanced. That is a windfall they won't give up easily.

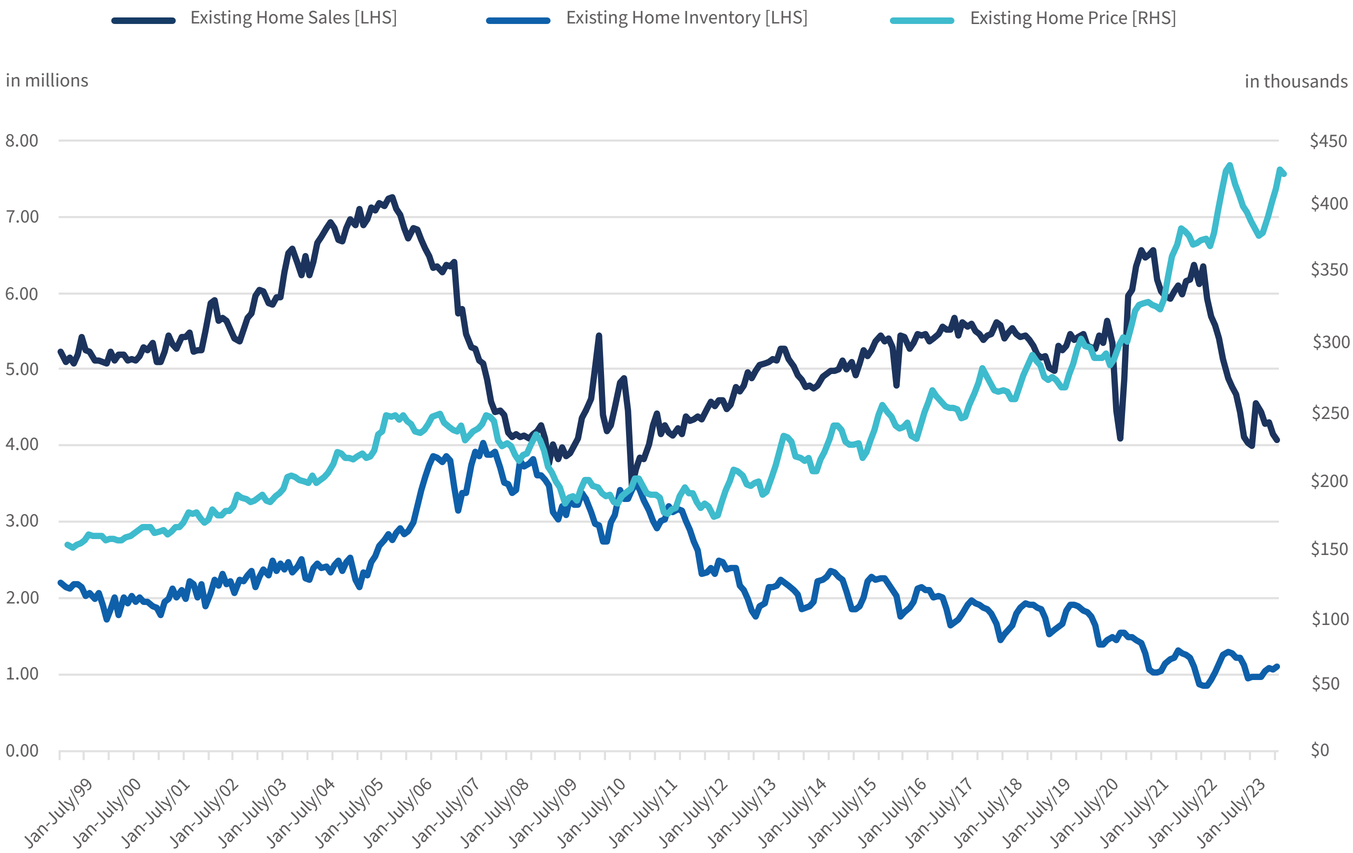
Monetary tightening since March 2022 has taken interest rates to their highest levels of the post-2008 financial crisis period, or even longer than that for other rates. The 10-year Treasury rate hovers near 4.3% even as financial markets anticipate an end in sight to the Fed's QT policies. Surprisingly, recent signs of a slowing labor market, cooler consumer spending and a likely Fed rate hike pause in September have not brought relief to this key interest rate, though it remains well below its average rate of 5.0% over the 20-year period that preceded the 2008 global financial crisis. (The Treasury yield curve remains inverted, with shorter-term Treasuries still above 5.0%.) Likewise, a 30-year fixed-rate mortgage remains stubbornly above 7.0%, its highest level in 22 years, representing a 60% increase in a monthly mortgage payment compared to mortgage rates that prevailed in 2020-2021 on the same amount of principal. Nonetheless, average home prices have barely budged despite the soaring monthly payment for a current home buyer.

Potential home sellers have withdrawn from the market in droves, with existing home inventory for sale hovering in the range of one million units to date in 2023, down more than 40% from average pre-COVID inventory levels, while existing home sales have plummeted by one-third this year compared to 2021 and by nearly one-quarter vs. pre-COVID levels, to their lowest levels since 2010 (**Figure 1**). One would think that the highest mortgage rates in two decades would cause a much-needed correction in home prices to restore market equilibrium, but that is hardly the case to date: average prices for existing homes are barely down from the record highs of early to mid-2022 (**Figure 1**). (Note: As imperfect as the average sales price for existing homes is as a gauge of home values for a variety of reasons, the S&P/Case-Shiller Home Price Index, a better price metric that only includes sales of matched-pair homes, essentially tells the same story. Its national and 20-city indexes are up for the year through July and are just fractionally below their all-time highs.)

Potential home sellers are not budging — figuratively and literally. And why should they? Moving, especially moving up to a larger home, would likely entail giving up a 3% mortgage for a 7% mortgage while still paying near top-dollar for a new home. It makes little economic sense. Home buyers, especially first-time buyers, who are transacting in this market are knowingly taking a gamble: incurring a monthly home financial burden that is larger than it has ever been in the hope that mortgage rates will soon recede and let them refinance at lower rates. Some buyers can only make the current math work with other financial sacrifices and are relying on a refinancing being possible within a couple of years.

The most troubling aspect of the current housing market dynamic is that there is little prospect it will resolve in the absence of significantly lower mortgage rates and/or meaningful new home supply, neither of which can happen quickly. This stalemate will continue to weigh down a host of industry sectors that are dependent on a robust housing market. This market dysfunction is the unintended consequence of record-low mortgage rates in 2021-2022 and is keeping potential sellers on the sidelines, maybe indefinitely.

Figure 1 - Existing Home Sales, Inventory and Prices



Source: Bloomberg and FRED (Federal Reserve Bank of St. Louis)

The Great Rate Debate

Those conditioned by more than a decade of low interest rates engineered by long periods of aggressive monetary easing and waiting for rate relief to come again may be in for disappointment. Many market rates of interest are benchmarked off comparable Treasury rates, either directly or indirectly, including home mortgages and corporate bond rates, which have remained stubbornly high even as inflation eases, QT winds down, and indications of economic slowing are becoming more apparent. One plausible explanation for rate stickiness gets less mention than it deserves: the deteriorating U.S. fiscal condition.

The August downgrade of U.S. sovereign debt from AAA to AA+ by Fitch Ratings was a seemingly momentous event that garnered considerable attention at the time but has quickly faded from the headlines. The Fitch downgrade comes 12 years after S&P downgraded U.S. sovereign debt to AA+ back in 2011. Of the 29 countries with AAA, AA+ or AA sovereign ratings from S&P, the United States currently ranks worst in its two categories of fiscal assessment (budget performance and debt).

More telling than the downgrade itself was the reaction from many prominent pundits, economists and financial commentators, nearly all of which were critical or dismissive of the downgrade, some aggressively so. But none of the criticisms offered substantive reasons why a downgrade of U.S. sovereign debt wasn't warranted, given the notable deterioration in our nation's fiscal performance and outlook. Their pushback amounted to little more than obvious cheerleading slogans. Several of these comments seemed to confuse the relative strength of the U.S. private sector with the deep challenges confronting the public sector. Indeed, many policy actions and measures taken in recent years to bolster the private sector, including the Trump tax cuts and massive COVID-era financial assistance, have come at tremendous financial cost to the federal government.

There appears to be a strong element of denial about how badly the U.S. fiscal condition has deteriorated since 2018. Federal budget deficits are projected to exceed $1.5 trillion annually (or 5.0%-6.0% of GDP) through 2028,[5] peaking at $1.8 trillion next year with a domestic economy near full employment. Federal debt held by the public is expected to soar to $36.1 trillion by the end of this decade, from $25.9 trillion currently.[6] Furthermore, $7.6 trillion of Treasury debt is scheduled to mature within the next year, representing 31% of outstanding U.S. public debt,[7] most of which will be refinanced at higher interest rates. Finally, there seems to be little political will or consensus in Washington to address burgeoning U.S. debt or to tackle budget imbalances from either the revenue or spending side of the equation — or to merely avoid the recurring spectacle of a looming federal government shutdown over pro forma budgetary matters. It is getting harder for the political and economic punditry to downplay such fiscal concerns.

All of this is to say that perhaps market rates of interest for U.S. Treasuries are entirely appropriate, given the nation's deteriorating fiscal outlook and huge upcoming borrowing needs by the U.S. Treasury. This has spillover implications for many other market-determined rates of interest impacting households and the corporate sector. Those hoping or expecting interest rates to "normalize" once QT is done may be waiting for Godot.

[1] Statista Research Department. 2023, July 12. U.S. Existing Home Sales 2005-2023.

[2] Mac, Freddie. 2022, April 25. Trends in Mortgage Refinancing Activity.

[3] Ibid.

[4] Ibid.

[5] Office of Management and Budget (OMB), The White House.

[6] Office of Management and Budget, The White House. Retrieved 2023, September. Analytical Perspectives, Budget of the U.S. Government, Fiscal Year 2024.

[7] Filip De Mott. 2023, September 8. $7.6 Trillion of U.S. Government Debt Will Mature in the Next Year, Adding Pressure on Rates. Markets Insider.

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