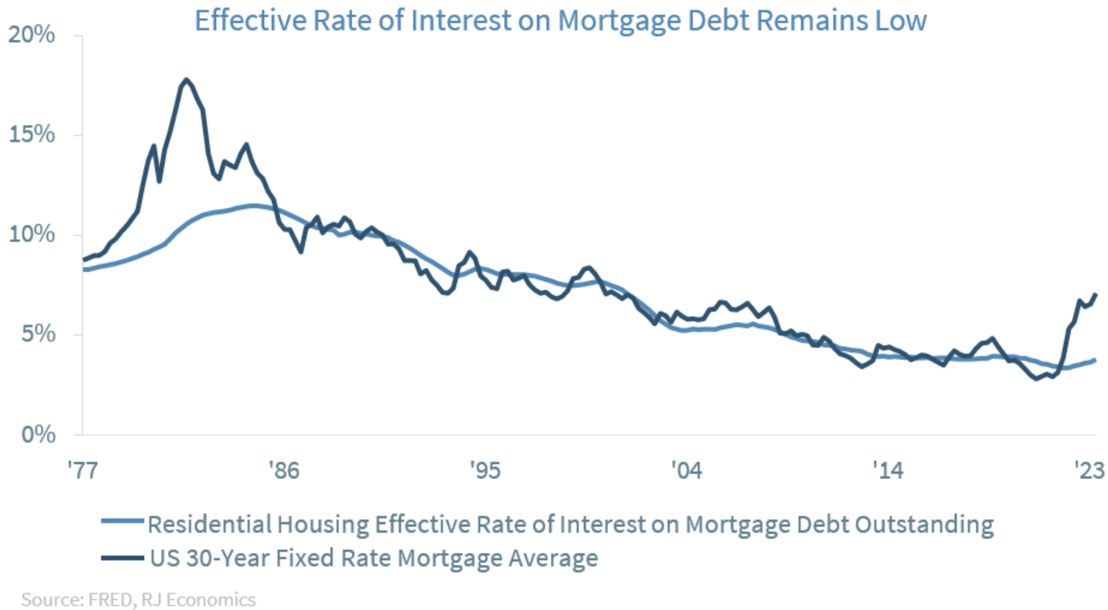
# Effects of higher interest rates on housing and consumers

**ECONOMY & POLICY**

January 19, 2024

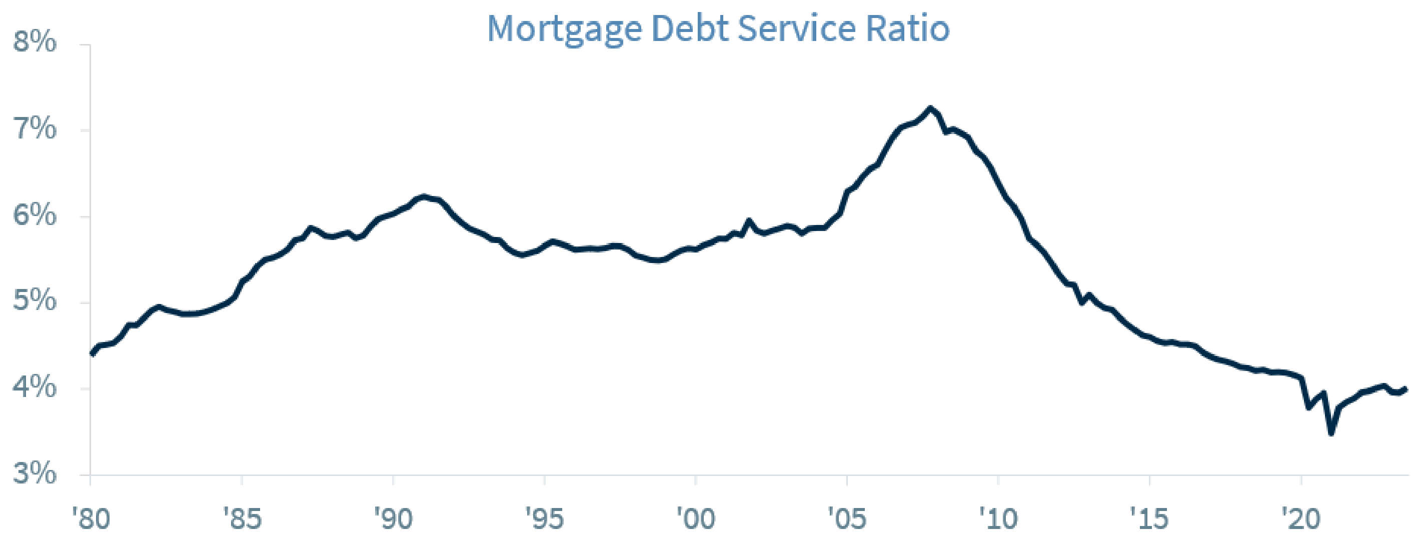
*Chief Economist Eugenio J. Alemán discusses current economic conditions.*

In our *Weekly Economics Thoughts of the Week* for last week, we showed that the housing market, i.e., real residential investment, had been one of the most impacted sectors by the increase in interest rates over the last several years with real residential investment declining for nine consecutive quarters, quarter-over-quarter, and then slightly recovering during the third quarter of last year, which is the latest available data. At the same time, the sales of homes, both new and existing, have continued to come down as the pool of potential homebuyers continues to shrink due to higher mortgage interest rates on home purchases. However, the increase in what American homeowners must pay on their mortgage, that is, the effects of the effective rate of interest on mortgage debt outstanding has been relatively small, as shown in the graph below, due to the characteristics of the U.S. fixed rate mortgage market.




Although 30-year fixed mortgage rates have almost doubled since the Federal Reserve (Fed) started its tightening campaign (and more than doubled from their lows in 2020), the effects over the level of the effective rate on mortgage debt outstanding have increased by just 13%. At the same time, we have not seen a buildup in dubious mortgages being sold right and left by unscrupulous mortgage lenders due to the guardrails built after the Great Recession. That has prevented the mortgage industry from relying on the mortgage products that gave rise to the housing market collapse of 2009-2010. Furthermore, the negative impact on Americans' ability to pay their mortgages has been minimal. Only those who have the income to buy new or existing homes at current prices as well as at current mortgage rates have been buying homes while those who had mortgages before the increase in rates have suffered no increase in mortgage payments over the last two years.

This is very clear by looking at the graph below, where we plot the mortgage debt service ratio, that is, mortgage debt service payments as a percentage of disposable personal income, which has remained at historically low levels and continues to show very little effect of higher mortgage interest rates on American families.

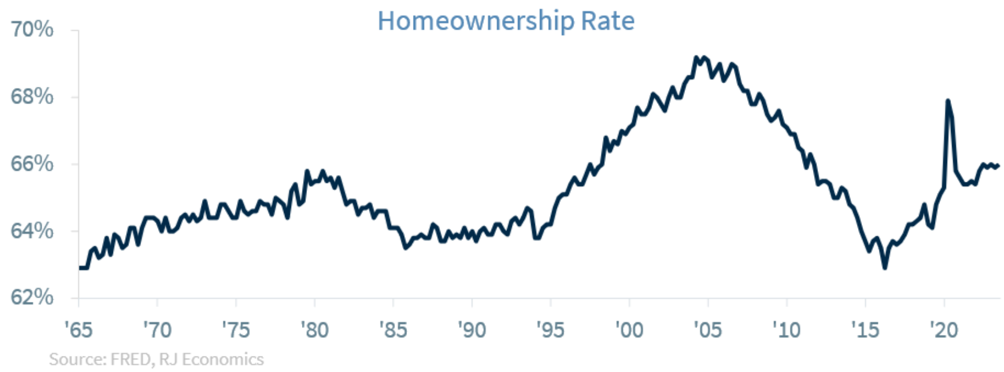



Source: FRED, RJ Economics

## But not all is rosy for American households.

The negative side of the strong increase in mortgage rates has fallen on those who did not have a home before the start of the increase in rates and on the ability of those Americans to purchase a home. Higher mortgage rates have priced many Americans out of the housing and mortgage market, putting further pressure on home rental and lease rates across the country. This is probably one of the reasons why shelter costs have continued to increase and the expected slowdown in those costs has not materialized as economists and analysts were expecting.

Thus, American families that lack a down payment as well as sufficient income to apply for a mortgage at these higher rates and current home prices, are probably the ones paying the largest share of the adjustment due to higher interest rates as home rental rates have continued to move higher. That is, according to the homeownership rate graph below, about 34% of American households today are renters and have been severely affected by the increase in rental rates across the US which comes on top of higher prices for all the other goods consumed by an average consumer. That is, those homeowners with or without mortgages have seen no meaningful increase in housing costs over the last several years while those who are not homeowners have taken a large hit on their purchasing power because of the strong increase in shelter costs.




*Economic and market conditions are subject to change.*

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*Consumer Price Index is a measure of inflation compiled by the US Bureau of Labor Statistics. Currencies investing is generally considered speculative because of the significant potential for investment loss. Their markets are likely to be volatile and there may be sharp price fluctuations even during periods when prices overall are rising.*

*Consumer Sentiment is a consumer confidence index published monthly by the University of Michigan. The index is normalized to have a value of 100 in the first quarter of 1966. Each month at least 500 telephone interviews are conducted of a contiguous United States sample.*

*Personal Consumption Expenditures Price Index (PCE): The PCE is a measure of the prices that people living in the United States, or those buying on their behalf, pay for goods and services. The change in the PCE price index is known for capturing inflation (or deflation) across a wide range of consumer expenses and reflecting changes in consumer behavior.*

*The Consumer Confidence Index (CCI) is a survey, administered by The Conference Board, that measures how optimistic or pessimistic consumers are regarding their expected financial situation. A value above 100 signals a boost in the consumers' confidence towards the future economic situation, as a consequence of which they are less prone to save, and more inclined to consume. The opposite applies to values under 100.*

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*GDP Price Index: A measure of inflation in the prices of goods and services produced in the United States. The gross domestic product price index includes the prices of U.S. goods and services exported to other countries. The prices that Americans pay for imports aren't part of this index.*

*The Conference Board Leading Economic Index: Intended to forecast future economic activity, it is calculated from the values of ten key variables.*

*The Conference Board Coincident Economic Index: An index published by the Conference Board that provides a broad-based measurement of current economic conditions.*

*The Conference Board lagging Economic Index: an index published monthly by the Conference Board, used to confirm and assess the direction of the economy's movements over recent months.*

*The U.S. Dollar Index is an index of the value of the United States dollar relative to a basket of foreign currencies, often referred to as a basket of U.S. trade partners' currencies. The Index goes up when the U.S. dollar gains "strength" when compared to other currencies.*

*The FHFA House Price Index (FHFA HPI®) is a comprehensive collection of public, freely available house price indexes that measure changes in single-family home values based on data from all 50 states and over 400 American cities that extend back to the mid-1970s.*

*Import Price Index: The import price index measure price changes in goods or services purchased from abroad by U.S. residents (imports) and sold to foreign buyers (exports). The indexes are updated once a month by the Bureau of Labor Statistics (BLS) International Price Program (IPP).*

*ISM New Orders Index: ISM New Order Index shows the number of new orders from customers of manufacturing firms reported by survey respondents compared to the previous month. ISM Employment Index: The ISM Manufacturing Employment Index is a component of the Manufacturing Purchasing Managers Index and reflects employment changes from industrial companies.*

*ISM Inventories Index: The ISM manufacturing index is a composite index that gives equal weighting to new orders, production, employment, supplier deliveries, and inventories.*

*ISM Production Index: The ISM manufacturing index or PMI measures the change in production levels across the U.S. economy from month to month.*

*ISM Services PMI Index: The Institute of Supply Management (ISM) Non-Manufacturing Purchasing Managers' Index (PMI) (also known as the ISM Services PMI) report on Business, a composite index is calculated as an indicator of the overall economic condition for the non-manufacturing sector.*

*Consumer Price Index (CPI) A consumer price index is a price index, the price of a weighted average market basket of consumer goods and services purchased by households. Changes in measured CPI track changes in prices over time.*

*Producer Price Index: A producer price index (PPI) is a price index that measures the average changes in prices received by domestic producers for their output.*

*Industrial production: Industrial production is a measure of output of the industrial sector of the economy. The industrial sector includes manufacturing, mining, and utilities. Although these sectors contribute only a small portion of gross domestic product, they are highly sensitive to interest rates and consumer demand.*

*The NAHB/Wells Fargo Housing Opportunity Index (HOI) for a given area is defined as the share of homes sold in that area that would have been affordable to a family earning the local median income, based on standard mortgage underwriting criteria.*

*The S&P CoreLogic Case-Shiller U.S. National Home Price NSA Index measures the change in the value of the U.S. residential housing market by tracking the purchase prices of single-family homes.*

*The S&P CoreLogic Case-Shiller 20-City Composite Home Price NSA Index seeks to measures the value of residential real estate in 20 major U.S. metropolitan.*

*Source: FactSet, data as of 7/7/2023*