The Rational Walk @rationalwalk

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Warren Buffett has referred to interest rates as "financial gravity" when it comes to asset prices.

Let's take a look at why this is the case in the market for the most important asset most Americans will ever purchase: A home of their own.

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The vast majority of Americans cannot come up with cash to purchase a home. The thirty year fixed rate mortgage is the most popular loan because of its long term and the stability provided by a fixed rate. The monthly payment is fixed for the life of the loan.

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In early 2021, the 30 year mortgage rate hit a record low well below 3%. A year ago, a credit worthy borrower would have paid 2.75-3%. In July 2021, I took out a 30 year fixed rate loan at 2.75% myself. It was a terrific deal.

Here's a chart of the 30 year rate over 5 years.

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Interest rates have been rising throughout 2022, and the 30 year mortgage is no exception.

Today, the rate is over 6%, more than twice where it stood a year ago!

This has a major effect on the economics facing Americans buying a home, as we will see.

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To make matters even more challenging, the median home price is higher today than it was a year ago.

But didn't Mr. Buffett say that interest rates are "financial gravity"?

He did, but the effects are not necessarily immediate.

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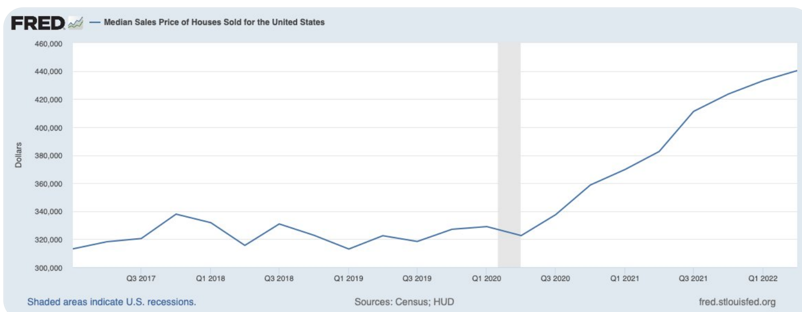

The St. Louis Fed's data shows the latest median home price at $440,300 but this is quarterly data. We can get a sense of trends by looking at industry data, such as this chart which shows median listing prices:

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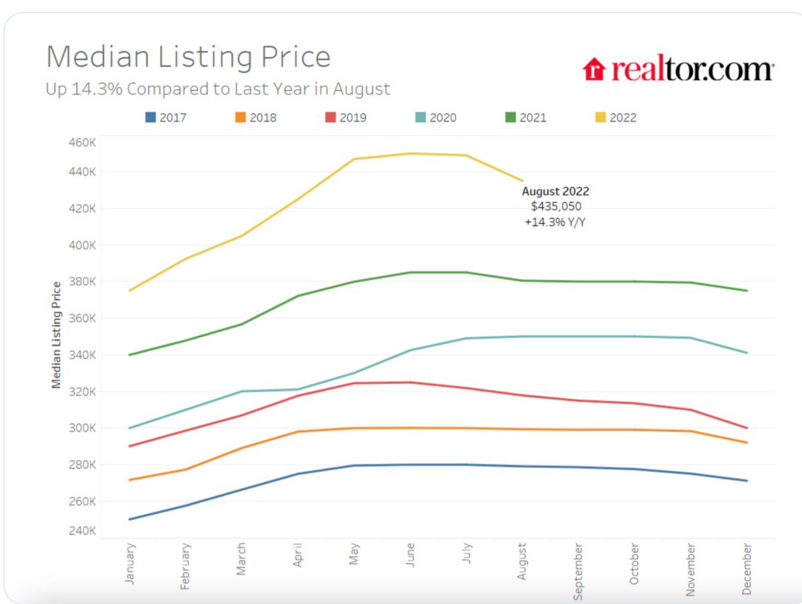

The FRED data shows that the median selling price was $411,200 in Q3 2021 while the buyer today is facing a median listing price of ~ $435,000.

So, let's consider the economics facing the buyer of a median priced home in September 2021 vs. September 2022.

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September 2021:

Median home price: $411,200
30 Year fixed rate mortgage: ~3%

Assume the buyer pays 20% down ($82,240) and takes a thirty year fixed rate mortgage for $328,960 at 3%.

The monthly payment would be $1,387.

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September 2022:

Median home price: $435,000
30 Year fixed rate mortgage: ~6%

Assume the buyer pays 20% down ($87,000) and takes a thirty year fixed rate mortgage for $348,000 at 6%.

The monthly payment would be $2,086.

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Not only would the buyer have to come up with a down payment that is $4,760 higher than a year ago, but the monthly payment would now be $2,086 compared to $1,387, a monthly increase of $699, let's round it to ~$700.

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The buyer today faces a monthly fixed payment of $700 more to buy the median home today compared to a year ago due to the combination of a higher median price and an interest rate that doubled from 3% to 6%.

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Paying $700/month, or $8,400/year more in debt service (comprised of interest and principal amortization) is a tremendous hit to household budgets when the median family income is in the neighborhood of $70,000/year!

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But let's flip the exercise and consider another scenario.

What would it take for the monthly payment to *remain the same* today as it was a year ago?

What can you get for a $1,387 monthly payment today?

Obviously, the home price would have to DROP, but by how much?

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If we wanted to keep monthly payments at $1,387 and if the 30 year fixed rate mortgage is 6%, the loan amount would have to be $231,340.

Assuming that this represents 80% of the home purchase price, with down payment still at 20%, the home price would have to be $289,175

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In other words, if the home price was $289,175 today, a buyer could put $57,835 down and take a loan for $231,340 at 6%. The resulting monthly payment would be $1,387.

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But the median home price did not FALL from $411,200 a year ago to $289,175 today.

The median listing price is now $435,000 according to industry estimates.

So because of that, the monthly payment to buy the median home has increased by $700.

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Median incomes, in nominal terms, have increased over the past year, but these increases have been more than swallowed up by consumer price inflation in areas other than housing. Real median incomes are down, not up.

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I am not suggesting that median home price would be "correct" at $289,175 today vs. $435,000.

I am saying that the monthly payment on a $289,175 home today would be equivalent to monthly payment on a $411,200 home a year ago.

The former is an opinion, the latter is a fact.

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But the median listing price *increased* to $435,000.

It seems like Mr. Buffett's "financial gravity" doesn't affect the housing market.

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Are homes overvalued today?
Were homes undervalued a year ago?

These are questions that can only be answered in the context of many other variables.

But, holding all of those variables constant, a doubling of the mortgage rate should cause homes prices to fall, not rise.

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Housing economics go far beyond mortgage rates. One has to consider HOA fees (if applicable), property taxes, insurance, and maintenance. These costs go up in inflationary environments. So, monthly cost of the median home is likely far more than $700 higher than a year ago.

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Mr. Buffett is right: Interest rates are financial gravity.

But unlike dropping an apple from a 30 foot building and observing the effect of physical gravity as it slams into the ground, the effect is not instantaneous with asset prices.

Especially home prices.

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