On the Minds of Investors

The impact of higher interest rates on housing and consumers

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Housing markets have boomed in recent years since the trough of the Global Financial Crisis (GFC), with buyers taking advantage of record low borrowing costs. Since then, however, central banks have had to push borrowing costs materially higher in a bid to see off soaring inflation. The question now is whether this environment of higher interest rates will prompt a new housing crash and a wider economic crisis.

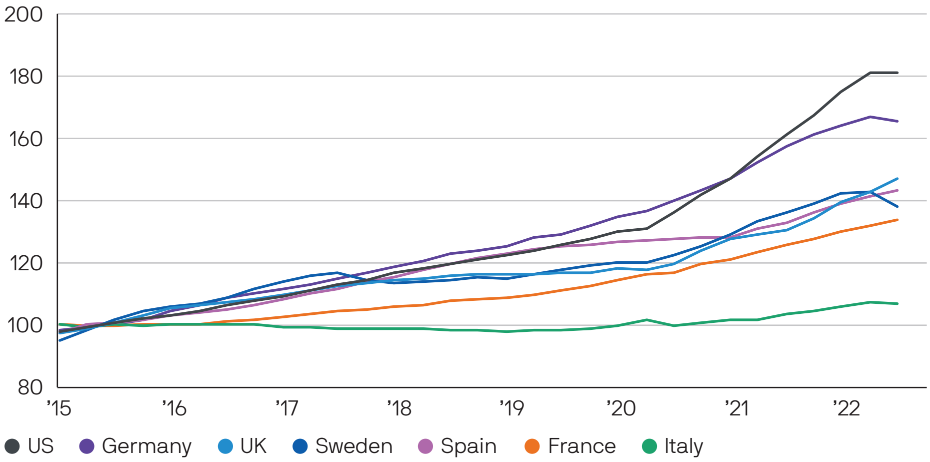
We believe that house prices are indeed due for a correction, which would have adverse implications for growth. However, there are several mitigating factors compared to the last crisis. Housing supply is low, maturities of average mortgages are longer, and labour markets are tight. Most importantly, banks' balance sheets are much stronger than before the financial crisis, making them less vulnerable to an economic downturn.

Central banks are throwing cold water on a hot housing market

Central banks' determination to bring inflation back to their targets has altered the fundamentals of the real estate market. The US, UK and eurozone all saw their fastest hiking cycles in more than 30 years, resulting in sovereign bond yields rising sharply across the board. Hence, mortgage rates have more than doubled from post-pandemic lows in the US and tripled in most European countries. Given the sharp rise in house prices over the past seven years (**Exhibit 1**), the surge in interest rates has depressed home affordability to the lowest level since the eve of the last housing crisis in 2006. In 2022, housing transactions fell sharply and house price data in the second half of the year had already started to signal a softening of the pricing environment in North America and Europe.

Exhibit 1: Nominal house prices

Index level, rebased to 100 in 2015



Source: OECD, J.P. Morgan Asset Management. Data as of 31 December 2022.

Housing market vulnerabilities

From the lows of the financial crisis, global nominal house prices increased by 75%, pushing the housing market in overvalued territory in North America and most European countries. Growth in disposable income hasn't been able to keep up over the same period. That's why many large developed economies currently have house price to disposable income ratios close to, or at historical highs (**Exhibit 2**). This leaves today's housing markets significantly more vulnerable to higher interest rates and financing costs. Overvaluation is not evenly spread, however. Japan, Italy and Spain are the only G20 developed market countries with ratios below their historical averages.

The relevance of the price to disposable income metric for the housing market outlook can be compared to price to earnings ratios for equites. In the short term, it has little relevance but valuations do matter for long-term performance. For example, the US experienced only two periods of major nominal house price declines in the past 50 years. Both periods occurred after the price to disposable income indicator shot above 1.0. In both cases, significant monetary tightening and a sharp rise in unemployment were required to cool house price exuberance. In Q3 2022, this indicator stood at 1.06 – a historical high (**Exhibit 3**).

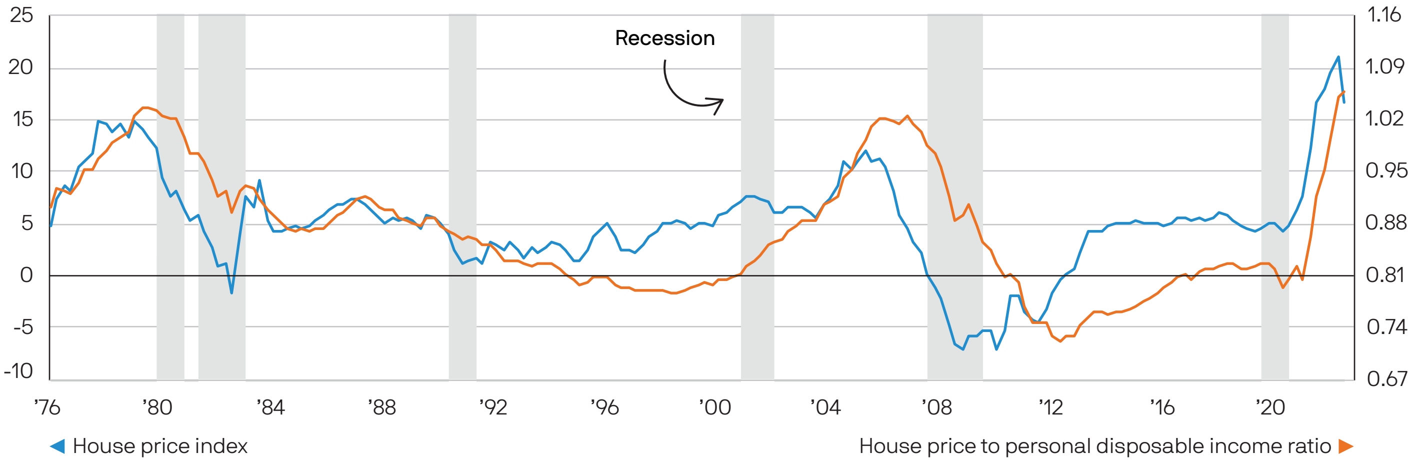
Exhibit 2: Ratio of house prices to personal disposable income

Ratio of nominal price indices rebased to 100 in 2005

Source: Federal Reserve Bank of Dallas, J.P. Morgan Asset Management. Data as of 31 January 2023.

Exhibit 3: US house price index vs house price to personal disposable income ratio*

% change year on year (LHS); ratio (RHS)



Source: Federal Reserve Bank of Dallas, J.P. Morgan Asset Management. Periods of "recession" are defined using US National Bureau of Economic Research (NBER) business cycle dates.

* House price index and personal disposable income index are rebased to 100 in 2005. Personal disposable income reported in per capita terms. Data as of 31 January 2023.

Since the beginning of 2022, interest rates on new mortgages increased considerably. In the US, annual 30-year mortgage costs for new homes doubled to 50% of household median income, while European mortgage rates tripled on average. Home affordability today is at a multi-year low. Housing transactions are falling sharply since a decreasing number of households can afford to purchase a house (**Exhibit 4**). However, evidence from the 1980s shows that even in phases of high financing costs, transactions in residential real estate never come to a complete standstill, since affluent households can reduce ongoing financing costs through taking a higher share of equity. Therefore, prime locations are more resilient in periods of housing weakness.

Moderate investment activity in this housing cycle has resulted in relatively low inventories, which is fundamentally different to the situation in 2006 where there was a big supply overhang in the US due to excessive building activity. The rental vacancy rate of 5.8% at the end of 2022 was significantly below the long-term average 7.3%. The lack of supply should mitigate the extent of the house price correction in the near term and turn into a tailwind as soon as interest rates and financing cost moderate.

For housing markets to find their balance, affordability needs to normalise. This can happen in three ways:

1. Nominal prices fall
2. Interest costs decline
3. Disposable income rises

In our view there is a good chance that all three variables will contribute to improve affordability. As we pointed out in our 2023 investment outlook: **A bad year for the economy, a better year for markets**, slowing economic activity in the West and diminishing supply chain disruptions should ease inflation through the course of 2023. This gives central banks the opportunity to pause and finally lower rates as inflation moves closer to target in 2024, helping to shorten the adjustment period in the housing market. As a reference, the three real house price corrections in the US over the past 50 years lasted between 2.5 and 5.5 years.

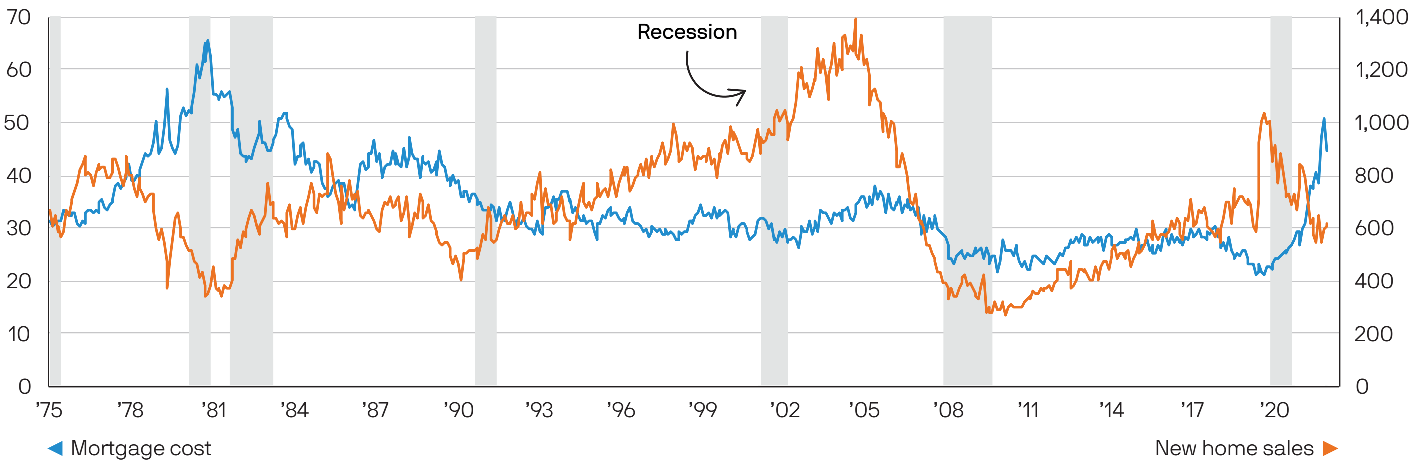
Impact on real economy and consumer

A downturn in housing can affect GDP growth in three ways: Reduced contribution from the construction sector, a squeeze on consumption, and the threat of a financial crisis.

A fall in transactions and less demand for houses have a direct impact on the value add in construction and related activities. At the peak of the housing boom in 2006, eurozone gross fixed capital formation in dwellings was 7% of GDP and fell to 4.8% of GDP at the post GFC trough in 2015. While construction sector weakness might contribute to weaker future growth, the sector is not big enough in North America and Europe to push the local economies into recession.

Exhibit 4: US mortgage cost vs single-family home sales

Mortgage payments as a % of median income (LHS); thousands (RHS)

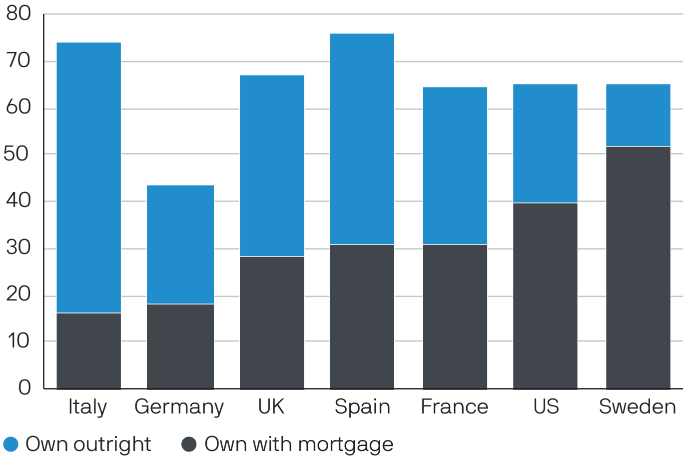


Source: Bloomberg, Census Bureau, J.P. Morgan Asset Management. Periods of "recession" are defined using US National Bureau of Economic Research (NBER) business cycle dates. Single-family home sales are seasonally adjusted and annualized. Data as of 24 February 2023.

Much more relevant is the impact on consumption, which is 68% of GDP in the US and 52% of GDP in Europe. Consumption can be negatively affected in two ways. Rising mortgage costs can eat into households' discretionary spending. The size of the impact varies from country to country, depending on the time it takes higher interest rates to pass through to homeowners. This is dependent on the proportion of equity in home ownership as well as the average maturity of mortgages. Italy and Germany look less vulnerable in that respect compared to Sweden, the UK and Spain. In the US, the share of variable rate mortgages shrunk from over 20% in 2006 to below 5% in 2022 and 30 year mortgages are now the most commonly used. However, the overall leverage in house ownership is relatively high (**Exhibit 5**).

Exhibit 5: Home ownership by mortgage status

% of households



Source: Eurostat, OECD, J.P. Morgan Asset Management. Data as of 31 January 2022.

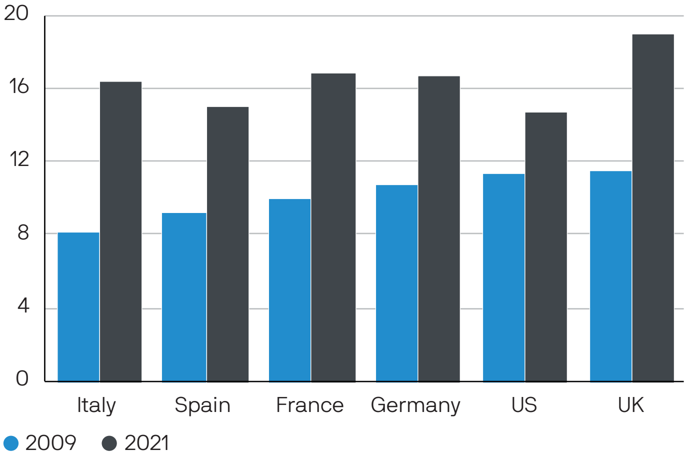
House price declines can also negatively impact consumption through the wealth effect as homes represent 29% of overall assets in the US. If unemployment doesn't rise significantly, the wealth effect may only be limited as households, in the absence of the threat of financial distress, have less incentive to ramp up their savings. However, previous US consumer-led recessions in the early 1980s, 1990/91 and 2008 were accompanied by sharp rises in unemployment.

Low housing affordability and high new mortgage costs can also have a negative effect on labour mobility. This amplifies the labour shortage in the US and Europe and dampen growth.

The biggest risk of a housing downturn is that it morphs into a financial crisis. Compared to 2006, banks are much better capitalised and credit quality is much higher (**Exhibit 6**). The US subprime market was 25% of overall mortgage origination in the years leading to the GFC, while today it is less than 8%. While an increase in delinquencies is a likely consequence of a housing downturn, the risks to the banking sector look more idiosyncratic than systemic. However, a pronounced downturn might force banks to tighten lending even further which could have negative repercussions for overall economic activity.

Exhibit 6: Core tier 1 capital ratios

%, regulatory tier 1 capital to risk-weighted assets



Source: IMF, Refinitiv Datastream, J.P. Morgan Asset Management. Core tier 1 ratios are a measure of banks' financial strength, comparing core tier 1 capital (equity capital and disclosed reserves) against total risk-weighted assets. *Guide to the Markets – Europe*. Data as of 31 December 2022.

Conclusion

The housing sector is currently very vulnerable to a downturn due to high valuations, rising interest rates and low affordability. Risks are unevenly spread globally due to diverse structures and the characteristics of local markets.

While a correction in house prices seems unavoidable, one of the key variables that will define the magnitude of the downturn is the success of central banks in containing inflation. Our base case scenario is that central banks will be able to at least pause tightening, with inflationary pressures easing, and return to a more accommodative stance in following years, limiting the downside in the housing market.

If inflation was to remain stubbornly high, hawkish central bank policy may accelerate house price declines. Rising mortgage costs cutting into discretionary income and negative wealth effect will depress consumer spending further, which could finally lead to a recession in Europe and the US. Nevertheless, even in an inflationary scenario, we are unlikely to enter a vicious cycle due to low inventories, better quality lending and stronger bank capitalisation.

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