THE Wealth REPORT

Recent signs indicate that the housing market may be approaching its peak. Long-term economic expansion, rising interest rates, an increase in nonprime loans, volatility in the securities markets and the possible threat of a recession lay new groundwork for what real estate investors can expect next.

HAS THE HOUSING MARKET REACHED ITS PEAK?

Overview

The economic expansion over the past nine years is the second longest the U.S. has ever experienced. If it continues past July 2019, it will officially become the longest in U.S. history. However, many experts are starting to see warning signs of a slowdown.

Specifically, the real estate housing market appears to be at or near its peak. According to the National Association of Realtors, prices have increased exponentially in recent years due to low supply. It appears that lessons from the last recession have stuck with many homeowners, who appreciate the fact that they simply have a home they can afford and are less interested in trading up.

There are other factors to consider. A recent survey of real estate experts revealed that if the economy does experience a setback, it will likely be due to an increase in interest rates set by the Federal Reserve.

Over the last 10 years, interest rates have hovered at or just slightly above historic lows. The Fed typically increases interest rates when growth and employment levels trigger higher inflation. By raising rates, money becomes more expensive to borrow and consumption is reduced, tamping down rising prices. This year, in response the country's continued economic growth, the Fed has raised interest rates three times and is expected to make one more hike by the end of the year.[1]

"A combination of high home values and rising interest rates has sparked concerns that the housing market may be due for a slowdown."[2]

Mortgage Rates

The Federal Reserve began raising short-term interest rates in 2015. Despite this defensive move, long-term rates remained surprising low. It has been primarily during the last year that rates have increased significantly, currently posting a full percentage point higher than a year ago, at around 5 percent for a 30-year mortgage.

Higher mortgage rates may discourage new and younger homebuyers, which is likely to stall overheated home prices and leave more homes on the market longer. Overall, home sales this year are expected to be lower than 2017 numbers.[3]

A lot of this may sound familiar, as if recent history is starting to repeat itself. We are only 10 years out from the last financial crisis, and wounds still run deep. In fact, mortgage values of more than 1 million American homes are still under water, and there are foreclosures from that period yet to be settled.[4]

Investment Opportunities

Investors have several options even in the wake of a declining real estate market. Those with available capital can purchase rental properties. Rents have been on the rise for years, to the point of making home ownership a more viable option. Rising interest rates may keep more potential buyers out of the market, offering up lucrative rental opportunities.

Owning rental properties is a viable long-term investment that generally poses less volatility than stocks. However, they have less liquidity, and building equity can take many years. It's important to invest in properties that generate enough income to cover taxes, insurance and maintenance so that investors aren't forced to pay those expenses out-of-pocket.

Investors can step back a bit further and invest in real estate investment trusts (REITS). These are fixed-income investments that invest in residential or commercial properties, or mortgage-backed securities. REITs are publicly traded, so they are as liquid as stocks and bonds. Note that their value is tied to interest rates, so income may fall when rates increase.[5]

Relaxed Lending Standards

Much of the rise and fall of the real estate market is tied to bank lending criteria. When standards are tight, only well-qualified borrowers can get capital, so there are fewer buyers in the market. During periods when lending criteria is less rigid, more people are able to buy homes. Unfortunately, it is during these more lax periods that more homeowners default on mortgage loans and foreclosures increase.

It's worth noting that lending criteria became more stringent in the years following the Great Recession. However, in the summer of 2017, high home prices and fewer homebuyers led Fannie Mae to once again relax its lending standards for prime loans. This enabled homebuyers with higher debt and lower credit scores to obtain loans without requiring a large down payment or excess cash reserves, which significantly increased the number of approved mortgages. There is also a trend to provide mortgages to people with credit scores as low as 500. While featuring higher interest rates and higher down payments, these "nonprime" loans may be offered to borrowers with recent negative credit events, such as a foreclosure or bankruptcy.[6]

These "covenant lite" loans are frequently securitized and packaged for sale to investors in the corporate bond market. Today, nearly 80 percent of newly issued loans are covenant lite, compared to fewer than 25 percent in 2006 and 2007.[7] Many of America's employees are already unwittingly invested in these higher risk corporate bonds through their employer pension funds.[8]

Final Thoughts

There are several ways to view a real estate investment. If you're a homeowner, rising values mean you build more equity and can sell your home for a higher price. However, if you don't sell, higher values could trigger higher property taxes. After the last real estate decline, many experts encouraged home buyers to view their homes less as financial investments and more as components of their lifestyles. If you stay put, you are likely to build equity over time and, since you have to live somewhere, your home serves a dual purpose.

If you're interested in buying and selling homes to accumulate assets, this strategy is reliant on timing within the real estate market and possibly contractor skills. Depending on your experience and savvy, flipping can be a high-risk investment strategy.

Then there are packaged real estate investments managed by professional money managers. It's important to recognize that even the pros experience significant losses, because no one can actually control the direction of the markets.

If you're looking to participate in the real estate market, consult with an experienced advisor who understands both the options available and your financial situation to help you choose the best scenario for your circumstances.

[1] Aaron Terrazas. Zillow Research. Oct. 15, 2018. "Rising Mortgage Payments Eclipse Home Value Gains." https://www.zillow.com/research/mortgage-payments-21610/. Accessed Oct. 17, 2018.
[2] Ibid.
[3] Diana Olick. CNBC. Oct. 9, 2018. "Mortgage rates jump past 5%, signaling more home price cuts ahead." https://www.cnbc.com/2018/10/09/mortgage-rates-jump-past-5percent-signaling-more-home-price-cuts-ahead.html. Accessed Oct. 17, 2018.
[4] Andrea Riguier. Marketwatch. June 30, 2018. "We're probably at peak housing. Here's what that means." https://www.marketwatch.com/story/were-probably-at-peak-housing-heres-what-that-means-2018-06-27. Accessed Oct. 17, 2018.
[5] Bobby Mantagne. Forbes. Sept. 21, 2018. "Four Ways Real Estate Can Boost Retirement Income." https://www.forbes.com/sites/forbesrealestatecouncil/2018/09/21/four-ways-real-estate-can-boost-retirement-income/#ce193a938d0a. Accessed Oct. 16, 2018.
[6] Diana Olick. CNBC. April 12, 2018. "Subprime mortgages make a comeback—with a new name and soaring demand." https://www.cnbc.com/2018/04/12/sub-prime-mortgages-morph-into-non-prime-loans-and-demand-soars.html. Accessed Oct. 17, 2018.
[7] John Glover. Bloomberg. Sept. 23, 2018. "Loose Leveraged Lending Is Storing Up Economic Trouble, BIS Says." https://www.bloomberg.com/news/articles/2018-09-23/loose-leveraged-lending-is-storing-up-economic-trouble-bis-says. Accessed Sept. 27, 2018.
[8] Knowledge@Wharton. Aug. 20, 2018. "How Dangerous Is the Corporate Debt Bubble?" http://knowledge.wharton.upenn.edu/article/corporate-debt-bubble/. Accessed Oct. 10, 2018.