SCHWARTZ Report

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A Home's Inflation Hedge

Neither a borrower nor a lender be for loan oft loses both friend and fortune.* Good Shakespearian advice, but what Polonius neglected to tell his son Laertes was that inflation helps debtors and deflation punishes them. Better said, there are times to court debt and times to turn away from it. Mortgage interest rates, for example, have been rising at a pace we haven't seen in years. Many of today's real estate practitioners, sales associates, and even some of their managers, have not seen a 30 year mortgage rate with a 5 or higher number in front of it. To quote real estate economist Ralph McLaughlin: "We've never seen a time where mortgage rates have risen so quickly and the market hasn't cooled off..." He is not in panic mode, nor should he be. He continues: "I don't expect the market to collapse by any means but certainly it's going to go from a gangbuster market to one that is more hopefully normal."

Therefore, if you are considering Polonius' advice and holding back from buying a home or a second one on credit because of higher borrowing costs, think again. Consider that annual inflation is on a faster track than are mortgage rates at least for now. In 2021 inflation was running at 2.6% higher than in 2020. Today it's at 8.5% or higher, depending on whose formula is used, than 2021. Mortgage rates look to be heading upward as well. Remember we are no longer using the term transitory to describe this inflation. Keep an eye on the 10-year U.S. Treasury which tends to move in tandem with the benchmark Fed funds rate and is the bellwether indicator for the direction that mortgage rates are heading.

If things continue along this path home buyers are better off borrowing money today, even to lock in a purchase at a higher price than they would like. That 5% loan will be paid back with devalued dollars that are quickly losing their purchasing power due to the current annual rate of inflation. This is not unlike a business that looks for a profitable spread between the cost of capital and the cost of production. And a business doesn't often get to live in its product. The fixed rate 30-year loan, which is an anomaly throughout the rest of the world, allows borrowers to repay it with cheaper dollars over a long term given even nominal rates of inflation.

Let's say that the rate of inflation returns quickly to the 4% per year that it averaged between 1972 and 2019. Well then you might say that your 5% loan is costing you 1% in real dollars. The other pressing issue that Polonius addresses is the loss of friend and fortune. Your new home should certainly be your friend but it is also your fortune. It will be a hedge against the ravages of inflation and is one of the strongest financial assets that most families will ever own.

Uncertain economic times like these lead even the most Pollyannaish of us to ask what would happen if there was a re-occurrence of the 2008 Great Recession and home values suddenly decline. The simple answer to that concern is that as long as the mortgagor has a stable job, and there are plenty of them out there, and can manage the mortgage, and doesn't have to move any time soon; a short term dip in housing prices should not be much of a bother. Furthermore, unlike the underlying causes of the 2008 banking crisis which sparked the recession, nearly half of mortgaged homes today are considered "equity rich". That is defined as those with loan balances that are no more than 50% of their estimated market value. It's quite a comfortable margin if the borrower doesn't do something foolish like siphon off that equity by refinancing for spendthrift purposes.

A good indicator of the health of homeowners' equity is that the percentage of mortgages that are between "forbearance" and "seriously under water" is now under four percent**.

The more likely scenario is that rising home prices will continue to keep pace with the rate of inflation at least until availability surpasses demand which appears to be sometime off. Supply side issues will continue to haunt the housing market. New home construction has always acted as a safety

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valve on sky-high demand. However, in a nutshell, we aren't building or re-habilitating at a pace that will take up the slack. Here is how National Association of Realtors (NAR) chief economist, Lawrence Yun describes the dilemma: "Leading up to the housing bubble heyday builders overbuilt. By my calculations, America had 2.1 million surplus housing units by 2006. Following the crash [in 2008], underproduction steadily chipped away at the surplus, such that inventory normalized by 2011. Continuing underproduction led to the housing shortage. By 2015 the shortfall was 2 million homes. That lack of inventory is why home prices are in no danger of falling sharply." Prudent home buyers should therefore continue to benefit from rising home prices.

*As quoted in Shakespeare's Hamlet Act I Scene 3, Polonius' actual statement is: "Neither a borrower nor a lender be, for loan oft loses both itself and friend, and borrowing dulls the edge of husbandry…" It is frequently shortened to what I have written above.

**ATTOM Data Solutions' 2022 U.S Home Equity and Underwater Report. During COVID there were a number of forbearance plans available. Generally the loan could be between one month and twelve months delinquent to qualify. Seriously under water properties have higher loan balances than their actual market value.

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