Are High Interest Rates Crashing the Housing Market?

Description

The Bank of Canada is aggressively increasing interest rates this year. The bank already did one 50-basis-point hike in April, and economists say that another one is coming in June. The commercial banks are already adjusting their mortgage rates in response to the central bank's actions. In May, Canadian mortgage rates were hovering around 4% on average. At the 2020 lows, they were near 2%.

Money is getting more expensive. And now, some think that the higher interest rates are crashing the housing market. Over the last two months, the average price of a Canadian house declined twice in a row, for a cumulative decline of 8.5%. In this article, I will explore the topic of interest rates and how they affect the housing market.

Higher interest rates make it more expensive to buy

Higher interest rates make it more expensive to buy any item. The more expensive it is to borrow, the higher the cost to the buyer who can't pay up front. Higher interest rates discourage borrowing because they make things more expensive holding the list price constant. For this reason, assets often go down in price when interest rates rise.

This effect is more pronounced with housing than most other assets. The price of a computer won't go down because of higher interest rates, because people don't need to borrow much if to buy it. But most Canadians finance house purchases by at least 90%. Not only are house purchases extensively mortgaged, but the size of the mortgages used is often orders of magnitude greater than the buyer's income. So, high interest rates tend to make house prices go down.

That's exactly what we're seeing this year. Interest rates are up and house prices are down. There is some reason to suspect that the interest rate hikes are causing the correction. We'd need a detailed statistical analysis to really prove that that's the case, but there aren't that many other thingshappening this year that could explain the crash. One possible alternative explanation is valuation.Canadian houses got extremely expensive relative to buyers' incomes last year, so perhaps a slightcooling would have occurred even without the rate hikes.

Banks may tighten

Another factor that may have contributed to this year's housing market decline is banking regulations. Late last year, the federal government strengthened mortgage lending rules, making the mortgage "stress test" harder to pass. The stress test is a hypothetical loan and interest rate that you need to be able to afford before you can buy a home. The interest rate used in the test is set higher than any interest rate you would actually pay in reality — the idea is to figure conservatively so that banks play it safe.

So, if you look at a bank like **Canadian Imperial Bank of Commerce** (TSX:CM)(NYSE:CM), it's likely to take a much closer look at borrowers' finances this year than in the past. CM issues a lot of Canadians' mortgages, and now, it is required to be stricter about who it will lend to. That's going to take a bite out of the housing market. Banks like CM can easily afford to take some risks with who they lend to — they are well capitalized, and their dividend payouts are far below their earnings levels. They're in a safe place already. Nevertheless, they will play it safer this year than they did last year.

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