Real Estate: No where to go.

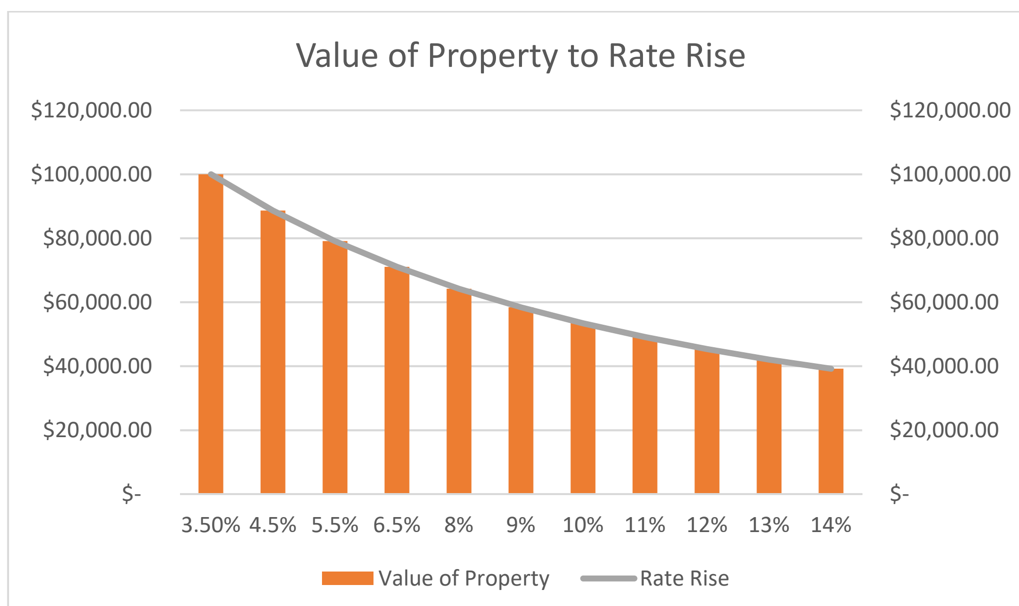
I did a little research about if rates rise and the numbers are quite scary on where we go from here regarding housing and the economy. Let's assume that the payments people are making on their homes today are at the top of their bandwidth based on current debt to income levels and stagnate wage growth. Therefore, if you were to hold payments constant, the only alternative, if the fed were to raise rates, would be to drop principal.

Example:

If you bought a $100,000 house today on a 30-yr. fixed mortgage at 3.5% your payment would be (excluding taxes and insurance) $449.04 a month. Now, assuming that you need to move, but rates have risen from 3.5% to 4.5% and the buying pool is essentially fixed (wages are what they are and are not rising). Therefore, the next buyer in that "pool" would only be able to afford, roughly that same payment of $449.04. But that payment today, because rates are now 4.5% not 3.5% would mean that the house once "worth" $100,000 would have to decrease in principal by approximately 11% - so the value of that home is now $88,624 to keep that same payment of $449.04.

That is a reduction in asset value of 11%. So, what does that do to the economy? Well, now you have lost 11% of your asset value, which means less money in the system to keep things moving forward in terms of multiplier effect. Sellers, who are often buyers at the same time, have less money to move from one property to another for down payments, spending at Home depot, hiring painters etc., all these result in a spiral that will drag the economy to a halt.

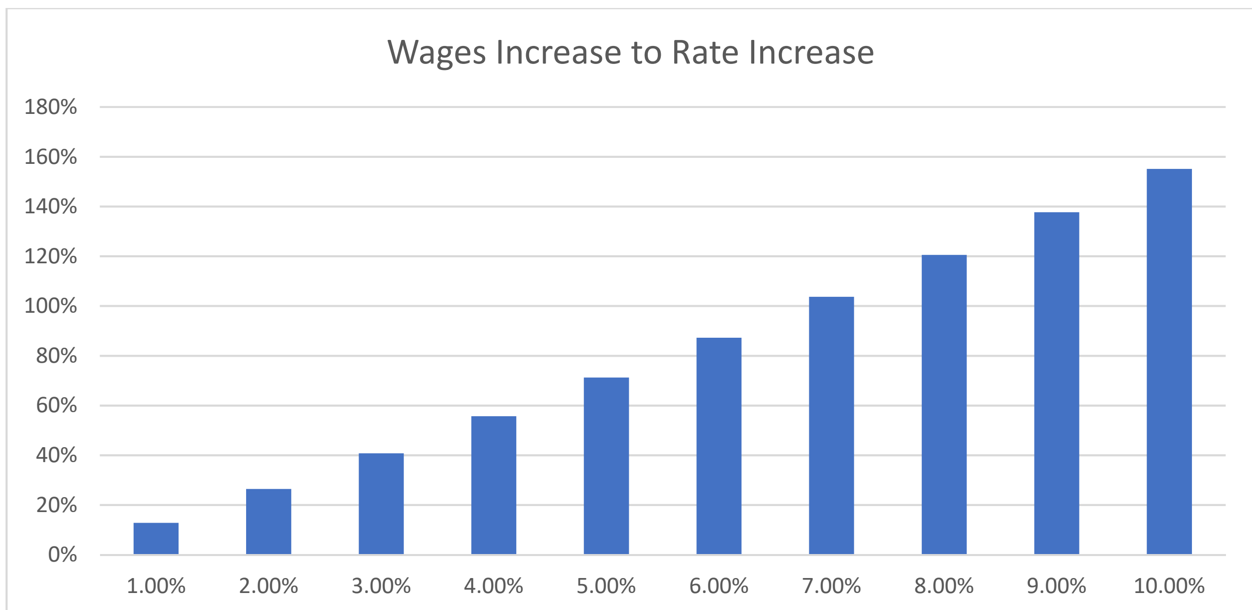
The graph below, Value of Property to Rate Rise shows that at 3.5% the value of the home is 100,000 (current market conditions) but as you move across the graph it shows the rate rise and what holding the payment constant would do to the value of the $100,000 house. In the event we reached hyperinflation, like the early 80's that 100,000 home at a 14% rate would have decreased in value by 61%. Meaning that house, holding the payment constant is worth roughly $39,203! WOW.

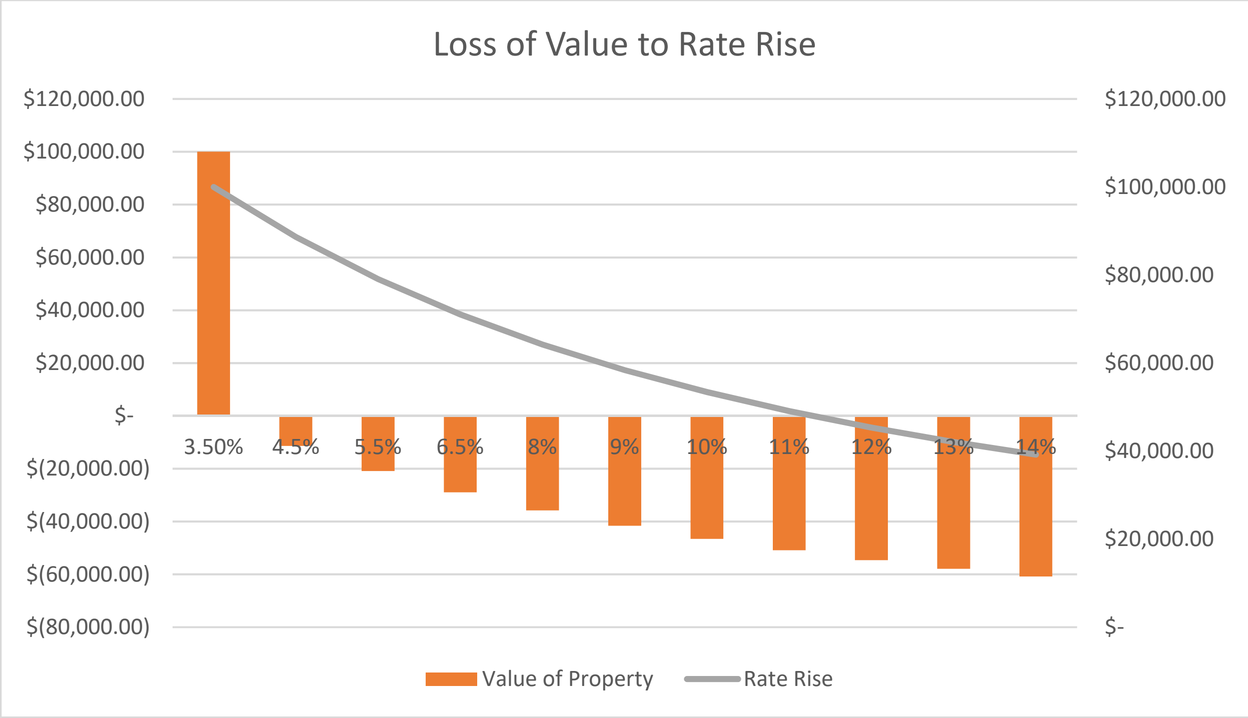


Alternately, assuming people could sustain upward pressure on payments due to a rate rise, then payments, with a 1% rise, would increase by nearly 13% to afford that $100,000 home. It gets much worse as the rates increase more and more.

It is very hard to imagine that even with a 3% rate rise – rates around 6.5% which are pre-2008 levels – that households could sustain an increase of 41% over current mortgage payment levels, provided wages have not risen close to that level for the working class in decades.  So, at current levels the payment for a $100,000 home is $449.04 but with a rate rise, of 3%, the payment for a $100,000 house is $632.07, an increase of $183.02 a month or $2,196 a year. Well, to folks making over a $100,000 year that increase probably seems reasonable. But the back of the napkin income level a buyer must generate is 3x the price of the home. So that $2,196 would need to be sustained by someone making roughly $33,333 ($100,000 / 3) a year. That is an increase in wages of 6.6% or more likely a decrease in spending power of 6.6%

So, you have a rising rate environment which is contractual to the economy– the more likely scenario is that people start to dedicate more to their discretionary spending to their household payment. In the case above that would need to be 6.6% of their check going to their house payment and not to other consumption. What does this mean? You have to take money "out" of our consumption system (people eat out less, buy less amazon, less boats) which in turn will drag the economy to a halt, which will cause job loss and economic decline – which will also result in a decline in house value as people lose their jobs, out migration, foreclosure rise, etc.






For higher earning people, here is an example of a 400,000 home. If you own a 400,000 home at 3.5% rate with a rate rise to 6.5% the following scenarios are the only outcomes. Assuming a tax rate of 24% and income level of 3 times home value.

The first scenario highlights the loss of asset value of $115,825 as buyers will not able to compensate their income levels to meet the rate rise obligation of a mortgage payment increase. This scenario seems most likely as wages have not increased in years of significant means.

| Yearly Income | Value of Asset | Rate | Duration | PMT | PMT Year Non-Adjusted | Income Adjustment before tax | PMT Adjust adding back income tax rate | New Income Level Adjusted for Tax Rate |
|---|---|---|---|---|---|---|---|---|
| $133,333 | $400,000 | 3.5% | 30 | ($1,796) | ($21,554) | $133,333 | ($26,727) | $133,333 |
| | $284,175 | 6.5% | 30 | ($1,796) | ($21,554) | $0 | ($26,727) | $0 |
| Delta (loss) | ($115,825) | 3.00% | 0 | $0 | $0 | $133,333 | $0 | $133,333 |
| | | | | | | 0.0% | | 0.0% |

The second scenario, assuming with a rate rise, you will still be able to get the value of underlying asset purchased at 3.5% while selling at a higher rate – which increases the payment a month. This scenario requires the buying pool to have more money to spend a month then it did before (as income levels rise the buying pool shrinks)

| Yearly Income | Value of Asset | Rate | Duration | PMT | PMT Year Non-Adjusted | Income Adjustment before tax | PMT Adjust adding back income tax rate | New Income Level Adjusted for Tax Rate |
|---|---|---|---|---|---|---|---|---|
| $133,333 | $400,000 | 3.5% | 30 | ($1,796) | ($21,554) | $133,333 | ($26,727) | $133,333 |
| | $400,000 | 6.50% | 30 | ($2,528) | ($30,339) | $8,785 | ($37,621) | $10,894 |
| Delta (loss) | $0 | 3.00% | 0 | ($732) | ($8,785) | $142,118 | ($10,894) | $144,227 |
| | | | | | | 6.6% | | 8.2% |

As the above depicts the buyer will need to pay $732 MORE a month to afford the 400,000 house! The after-tax implications are even worse, if you hold payment constant a decrease of purchasing power of 8.2% at a tax rate of 24% will be felt nationwide! If you raise tax rates to the following levels and hold asset values constant, we can assume a decrease in purchasing power of consumers similar to the table below.

| Tax Rate | 24.00% | 34.00% | 44.00% | 54.00% | 64.00% |
|---|---|---|---|---|---|
| Loss of Purchasing Power | 8.17% | 8.83% | 9.49% | 10.15% | 10.81% |

The third scenario is extending duration:

| Yearly Income | Value of Asset | Rate | Duration | PMT | PMT Year Non-Adjusted | Income Adjustment before tax | PMT Adjust for Income Tax | New Income Level Adjusted for Tax Rate |
|---|---|---|---|---|---|---|---|---|
| $133,333 | $400,000 | 3.5% | 30 | ($1,796) | ($21,554) | $133,333 | ($26,727) | $133,333 |
| | $400,000 | 6.5% | 50 | ($2,255) | ($27,058) | $5,504 | ($33,552) | $6,825 |
| Delta (loss) | $0 | 3.00% | 20 | ($459) | ($5,504) | $138,838 | ($6,825) | $140,159 |
| | | | | | | 4.1% | | 5.1% |

The idea of extending duration is the only remaining financial "trick" to keep the music playing (time you must pay off your loan, think car loans, people could not afford 5 yr. loans, so dealers offered 7 yr.) – though you would think banks would be concerned stretching the terms of the loans past the depletion timeframe of the asset – GAAP says a houses structure, if you put no money into will be worth zero in 27.5 years. In any event, assume this is possible and policy is changed to allow government back loans to extend 50 years. Even if you were to increase the loan to 50 years (AN INCREASE OF 20 YEARS) your payment would still increase by $459 a month resulting in decreased purchasing power of 5.1%! The problem with this "fix" is you can only squeeze so much principal out of a loan that is already amortizing 30 years so going out farther when 30 years is already a long time does little to curb the payment increase. Unlike car loans, where they were "short" term to start with.

My research leads me to believe either will we never see rate rises and continue the insanity probably ending in complete revolt or we will see rates rise and we will see a complete revolt because everyone lost everything in the collapse. Neither is a scenario I want to see happen. My research just reinforces what is being said by some, we are failing as a society to make this place a better place for future generation as our future generations are never going to obtain what we have today as we have fleeced this country of all that it can produce. The only solution out of this mess is simple, but not so simple, wages need to rise in the middle class (if rates rise wages must grow a minimum of 8.2% to sustain asset levels). There are much smarter people then me working on this idea but in any event, there needs to be compromise on the accumulation of wealth at the top or in the end we (the bottom 98%) are all going to be hurt, and a revolt of cataclysmic levels will be seen!

I will not go into a political debate but as anecdotal evidence we are seeing wages rising around 3.9% with unemployment around 3.85% which is essentially full employment…. highlighting the fact that profits are being made but wages are not growing as they should - far short of 8.2% increases we need to see in a rising rate environment. This tells me the system is to top heavy and not enough of the wealth is reaching the employees. In the end, though this research is about rate rises, which are necessary, they are not the problem. The problem lies in the fact we want to continue to ignore wage increases for the masses by pointing out how paying people more will hurt small business? Well, what about big businesses? They hid behind the little guy saying see, wage increases kill small business, which I agree can kill small business. But it does not kill big business. The game is rigged against the little guy and until we address this issue and point our finger at the big businesses and financial industry the problem will not be solved, only kicked down the road for our children to deal with it. Seems like a pretty chicken shit way to solve the problem to me. I rather endure a little less if it means my kids can endure a little more!