Is the Housing Market About to Crash?

High mortgage rates have doused the previously red-hot housing market, with more pain on the way as the Federal Reserve continues to raise rates. But in most areas, a correction is more likely than a crash.

As of February, existing home sales were down 22.6% from a year earlier.*

Anybody looking to buy a house right now faces a grim reality. Although prices have started to come down in many areas and inventory has improved, affordability has plummeted due to sharply higher mortgage rates. According to Freddie Mac, the average rate on a 30-year conventional mortgage was 6.6% as of March 12, 2023 -- more than double the 3.11% rate at the start of 2022. On a $300,000 mortgage, that translates into a monthly payment of $1,916 versus $1,283 -- close to 50% higher.[1] Ouch!

With many prospective buyers now priced out of the market and more rate hikes on the way, the question on everyone's mind is: Will the housing market crash?

The Long-Term Perspective

Fear of a crash is in part driven by memories of the mid-2000s housing bust, when house prices dropped over 25% on average and more in overbuilt areas. Foreclosures skyrocketed as millions of over-leveraged homeowners found themselves owing more than their house was worth. It took over 10 years for average home prices to fully recover.

Thankfully, circumstances are very different today.

Perhaps the biggest difference is in supply. Back then, many markets were flooded with new construction. Spec building was widespread. Today, the inventory of new and existing homes for sale remains near historic lows, propping up prices despite higher mortgage rates. And with 70% of homeowners sitting on a mortgage rate of 4% or less, many are opting to stay put.

Lending practices have also improved. Back in 2006, banks were handing out no-doc mortgages like candy -- some for the full value of the property. House flipping was rampant. So were foreclosures once prices started to drop. Regulators subsequently instituted stricter lending guidelines, so that today, homeowners stand on much firmer ground than those coming out of the financial crisis. As of February, distressed sales -- foreclosures and short sales -- accounted for only 2% of volume, unchanged from a year earlier.*

The Short-Term Perspective

It's also helpful to put today's soft market in context with the recent past. By any measure, the housing market during the COVID crisis was exceptionally strong -- and a tough act to follow. According to the S&P Case-Shiller Home Price Index, the average home price grew over 45% between January 2020 and June 2022 -- its steepest rise ever. In 2021, home prices skyrocketed over 25% in some areas. Bidding wars were common. Properties often sold in a day and for well above their asking prices.

Clearly, such frenzied conditions are unsustainable. Most real estate analysts view what's happening today as a return to reality. Just as the stock market experiences periodic corrections, so too does an overheated real estate market.

As of February, existing home sales were down 22.6% from a year earlier, though up from January, and ending a 12-month streak of declines, according to a March report by the National Association of Realtors.* The median price was down 0.2% from a year earlier, with the biggest declines in the West and Northeast. The inventory of unsold homes was up, as was the average time spent on the market -- 34 days versus 18 a year earlier.

Economic Fallout

Although these figures are cause for concern, they do not pose any imminent threat of a crash. More worrisome, perhaps, is how a real estate correction might impact the overall economy. Home prices play a big role in how Americans make decisions and spend money. Real estate workers, lenders, builders, and the home improvement industry all depend on the health of residential real estate. In fact, the housing industry as a whole accounts for about 15% to 18% of gross domestic product.[2]

Given the already tenuous economic outlook as a result of the Fed's ongoing rate increases, a further softening of real estate could tip the U.S. economy into recession. That, in turn, would put further downward pressure on real estate markets.

How bad a real estate correction is in store and whether or not it will force the U.S. economy into recession are both unknowns. But prospective buyers and sellers will want to keep an eye on trends. You should also bear in mind that real estate conditions vary widely from region to region, from city to city, and from neighborhood to neighborhood. So be sure to work with a local professional who is familiar with the unique dynamics of your area.

*Source: National Association of Realtors, March 21, 2023.

[1]Example assumes a 30-year fixed mortgage, $300,000 principal, not including taxes and fees, and interest rates of 6.73% and 3.1%. Mortgage rate source: FRED Economic Data, St. Louis Fed, as of December 30, 2021, and March 6, 2023.

[2]National Association of Homebuilders, *Housing's Contribution to Gross Domestic Product*.