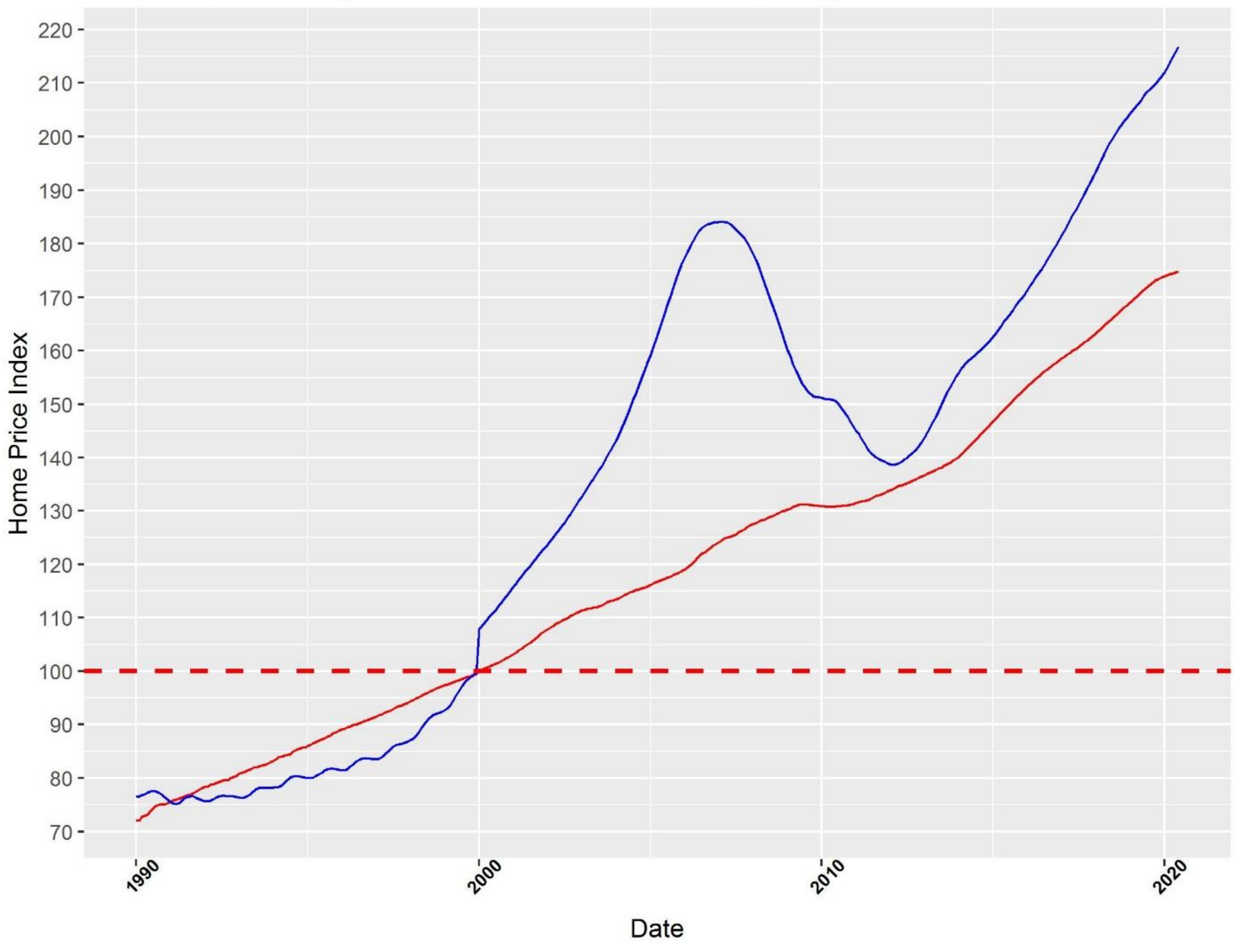
The 30-year mortgage rate has dropped to roughly 2.88 percent at the tail end of Oct-20. Home prices have responded accordingly. Zillow.com reports that the median home price grew at a 5.8 percent annual rate in Sep-20. If we look at Chart 1 below, we see that over the past several years home prices have risen at a faster rate than rents. This is good for the owners of single family properties, but makes it harder for current renters to get into a home. It also pushes potential buyers to stretch financially to get into the now ever-more expensive home. The higher home price appreciation (HPA) as shown in Chart 1 looks as if it is 2005 all over again. Is the Federal Reserve inadvertently creating a new housing bubble?

Chart 1. Home Price Index Relative to Rent Index, How Overpriced Are Homes?

The home price index growth relative to rents was 23.9% higher by Jul-20



Sources: Case Shiller and Zillow.com

There are several problems with this view: First is that underwriting standards have been tight from 2009 to 2020 and second, most homeowners have built up plenty of equity due to prices rising for several years. Furthermore, lower mortgage rates allows current homeowners to refinance and service their debts easier. We see the impact of lower mortgage rates on the cost of owning more clearly in Chart 2.

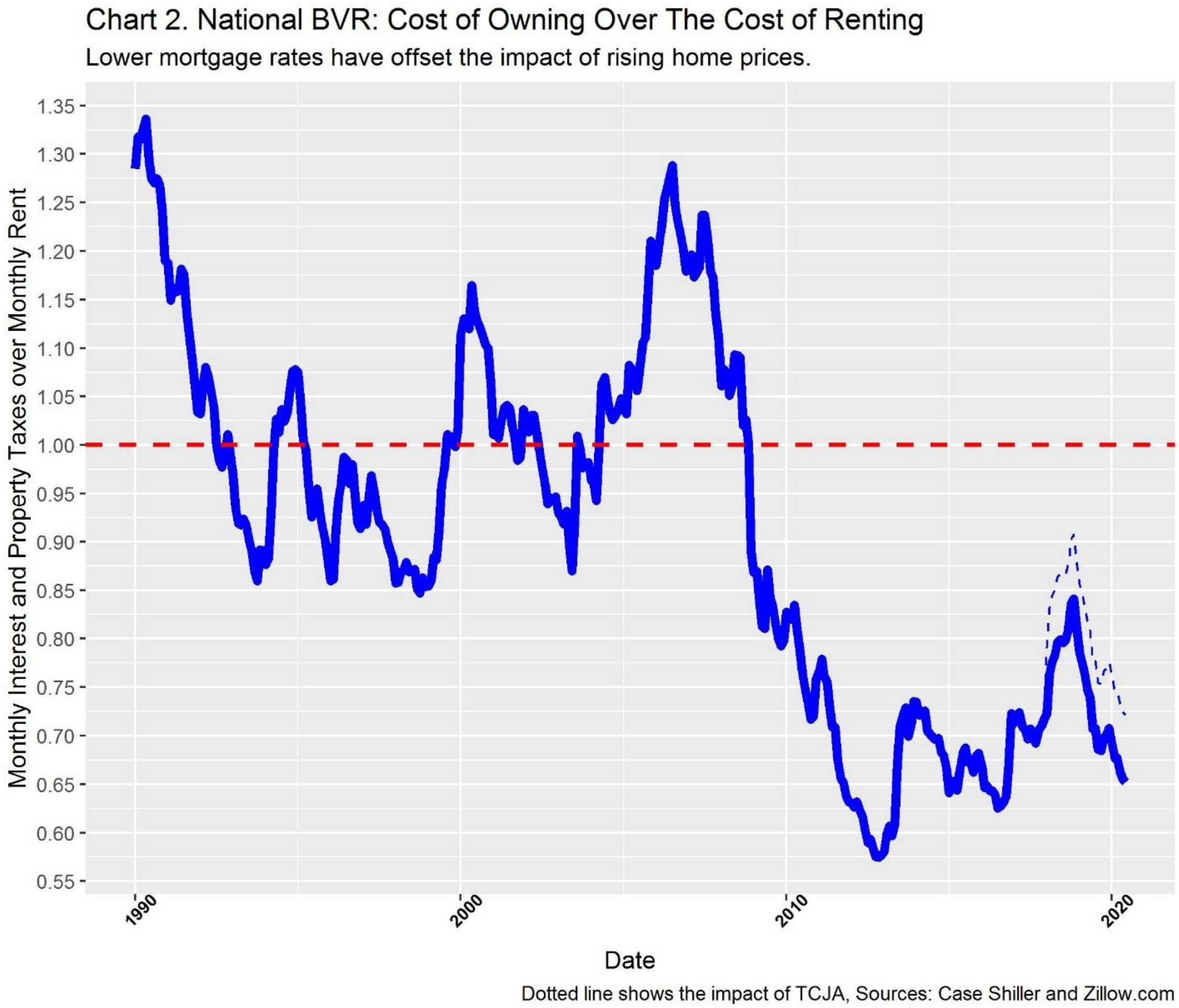


Chart 2 shows the ratio of the cost of owning a single family home (interest, property taxes and maintenance costs minus the benefits of state and local tax deductions) divided by the cost of renting. The cost of owning in economic parlance is called the User Cost of Capital (identified above by the variable B for buy). As long as two properties are nearly identical in location, size and construction, the cost of owning should be close to the cost of renting. If property prices are too high (BVR > 1) then people should rationally choose to rent. This would increase the demand for rental property and reduce the demand to purchase a house. In such a dynamic, rents would rise and prices would fall and BVR would nudge itself back closer to one. We can see this equilibrium dynamics playing out during the years 1995 to 2005. More recently, continually lower mortgage rates have push the national BVR to hover near 0.70 (even as the 2017 Tax Cuts and Jobs Act raised the cost of owning (dotted line)).

Chart 2 shows the 05/07 housing bubble and the subsequent popping of the bubble in late 2017. It also shows that the current environment is not a re-play of 05/07. At current mortgage rates, there is a strong incentive to buy a home. For now, buyers are rational.