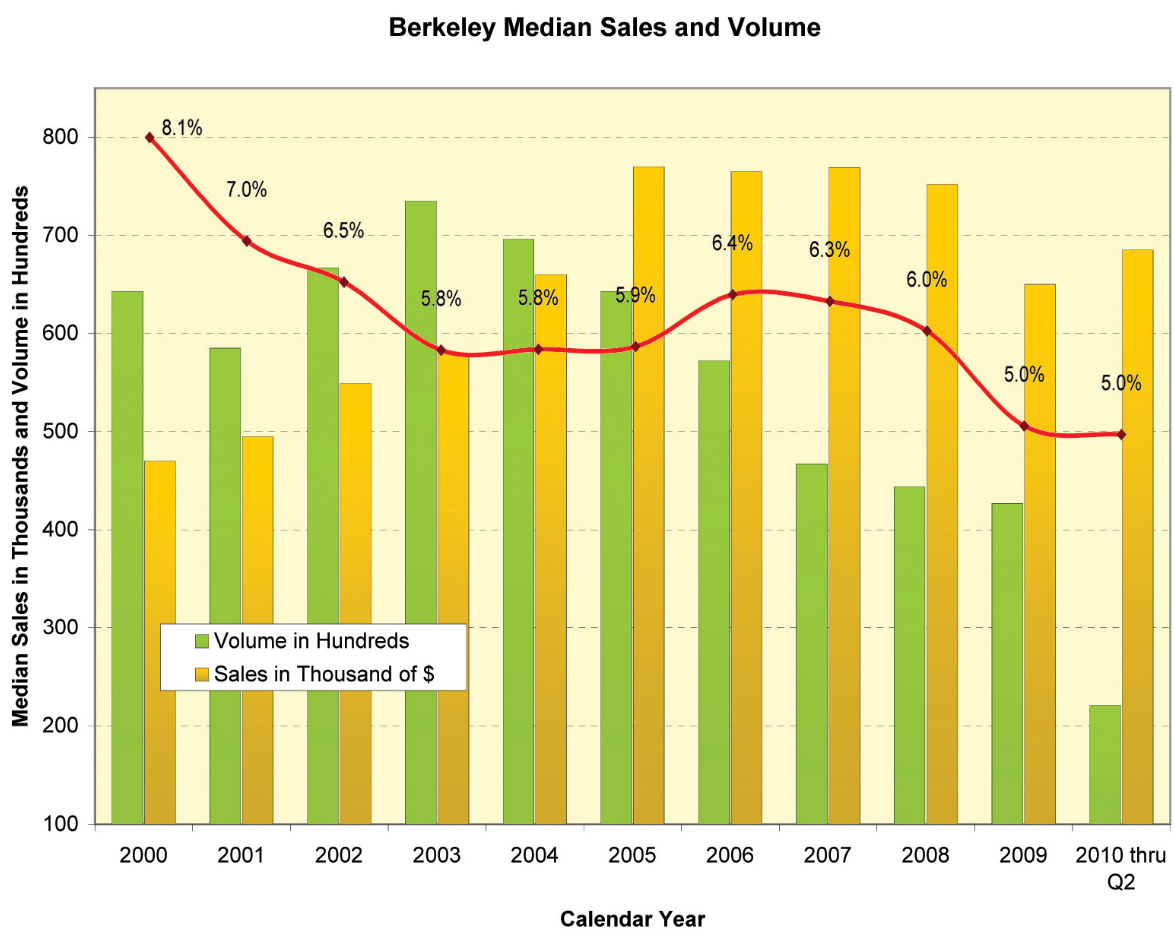
HOME AFFORDABILITY: PURCHASE PRICE VERSUS INTEREST RATES

In mid-August, interest rates hit historic lows of 4.44% for conforming 30-year fixed rate loans. Interest rates are one of the key factors that influence buyers in terms of when they purchase and how much they spend. A common determinant for how much buyers spend on a home is based on the monthly payment they can afford. The two components making up the monthly payments are the loan amount and the interest rate.

Using Berkeley as a good model for our local market (it has a broad range of home prices), the graph examines the past 10 years of both median home prices (in thousands of dollars) and sales volume (in hundreds) through June 30, 2010, with the average annual interest rate for 30-year fixed mortgages (*Source: Freddie Mac*) superimposed in red.



Conventional wisdom suggests low interest rates stimulate sales volume, which in turn reflects in stability or growth in home values. This same wisdom indicates that when the economy strengthens and sales volume rises, those interest rates do the same. There are numerous other factors that affect home sales, such as the health of the economy, job security and affordability. Although it is too early to forecast with great confidence, we do see evidence that home prices have at least stabilized.

Currently, buyers fear that prices may drop again, thus they are waiting for the "great deal." This knowledge stimulated an analysis of the effect of rising interest rates versus dropping home prices using the monthly payment as the key factor for home buyers. We used the current median sales price in Berkeley for the example below.

	Loan Amount = 80% of Purchase Price				
	Baseline Purchase Price of **$700k**	Purchase Price Reduced by **3% ($21k) to $679k**		Purchase Price Reduced by **6% ($42k) to $658k**	
Interest Rate ~ 30 yr fixed	Monthly Payment on $560k loan	Monthly Payment on $543k loan	Diff between Baseline interest rate of 4.5%	Monthly Payment on $526k loan	Diff between Baseline interest rate of 4.5%
4.50%	**$2,837**	$2,751	-$86	$2,665	-$172
4.75%		**$2,833**	-$4	$2,744	-$93
5.00%		$2,915	$78	**$2,824**	-$13
5.25%		$2,998	$161	$2,905	$68
5.50%		$3,083	$246	$2,987	$150

The table illustrates that it takes but a **3% drop** in purchase price to offset an **increase** of as little as ¼% in interest rates. Our **conclusions** in brief are that:

1) it's impossible to know when the market has bottomed out until it begins to rise again;
2) it takes a small shift in rates to increase the cost of home ownership;
3) with many fine homes sitting on the market longer than we are accustomed, making an offer below list price can be a wise, long-term decision.

With so many variables to consider and with a shifting market, please call for a current assessment and a personal consultation.