Weekly Real Estate Statistical Update

Up-to-date data on crucial California real estate trends from first tuesday

April 21, 2014 • Vol. 3 • Issue 16 • ***Homebuyers ARM themselves to combat rocketing prices***

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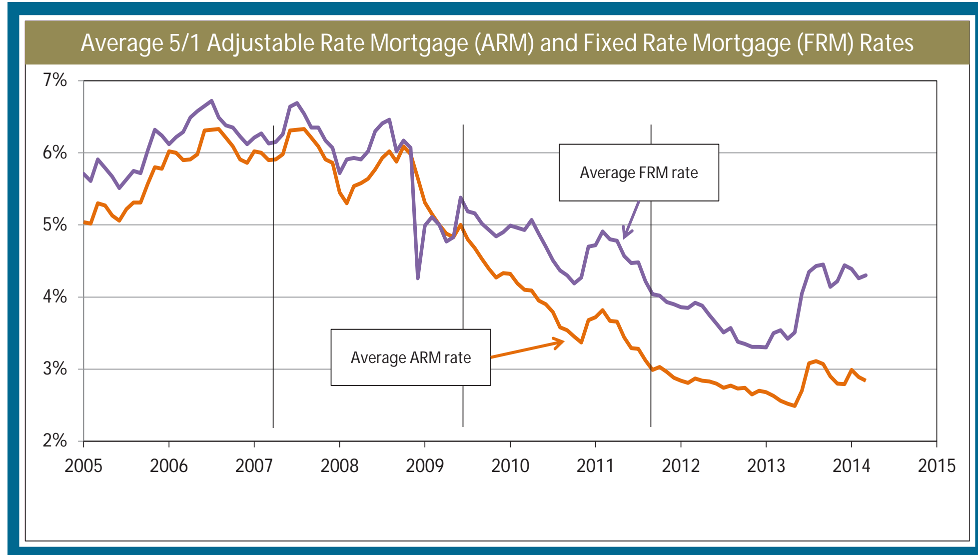
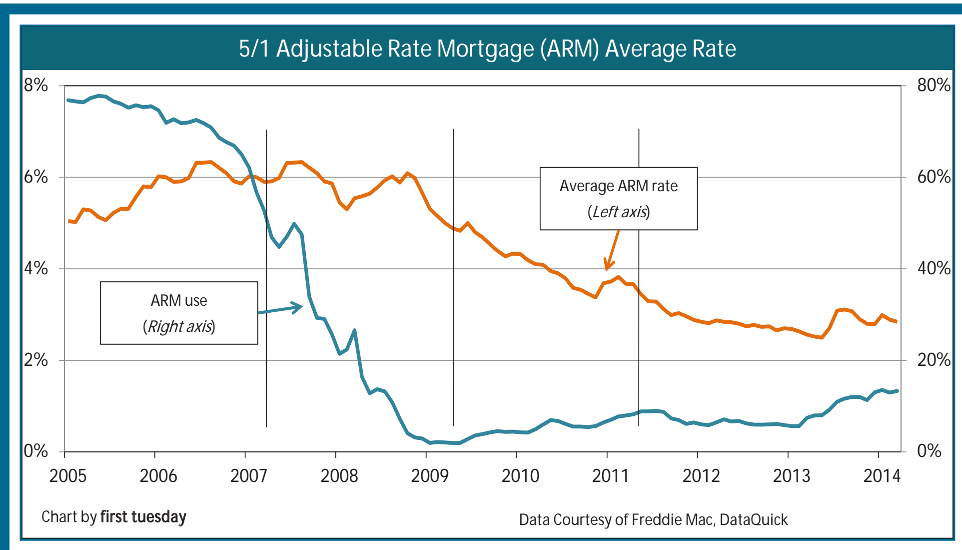
Lucrative ARM rates invite risk

This chart compares the average 5/1 **adjustable rate mortgage (ARM)** rate with the **fixed rate mortgage (FRM)** rate since 2005.

The average 5/1 ARM rate decreased slightly in March 2014 to 2.89%, down from 2.99% in February, but still above the May 2013 low point of 2.63%. In comparison, the 30-year FRM rate averaged 4.3% in March. When FRMs rates are steady, homebuyers choose FRMs over much riskier ARMs. However, when other market pressures exist, such as rapidly rising prices, even **well-informed homebuyers** opt for ARMs. Often, they are later unable to make the adjusted payments once the rate resets.

ARM use rose when FRM rates spiked in mid-2013 concurrent with the jump in home prices. Expect ARM rates to also rise consistently once the **Federal Reserve (the Fed)** raises short-term rates, likely before 2016.





ARM use on a short-term price bounce

This chart compares the average 5/1 ARM rate with **ARM use** in Southern California since 2005.

The average ARM use in March was 13.3% of all residential mortgages, up from 12.9% in February and 7.4% one year ago. When the average ARM rate peaked in 2006 surpassing 6%, ARM use was extremely elevated at 71% of all mortgages originated, as ARMs are the primary source of financing for subprime borrowers. Heavy use of ARMs is always a **recipe for disaster** in the housing market.

Presently, ARM use has increased due to home prices rising faster than the **rate of consumer inflation** (driven by speculation) and buyers taking on risk to extend their purchasing power. ARM use will slip later this year as home prices are pulled downward by a lack of buyers.

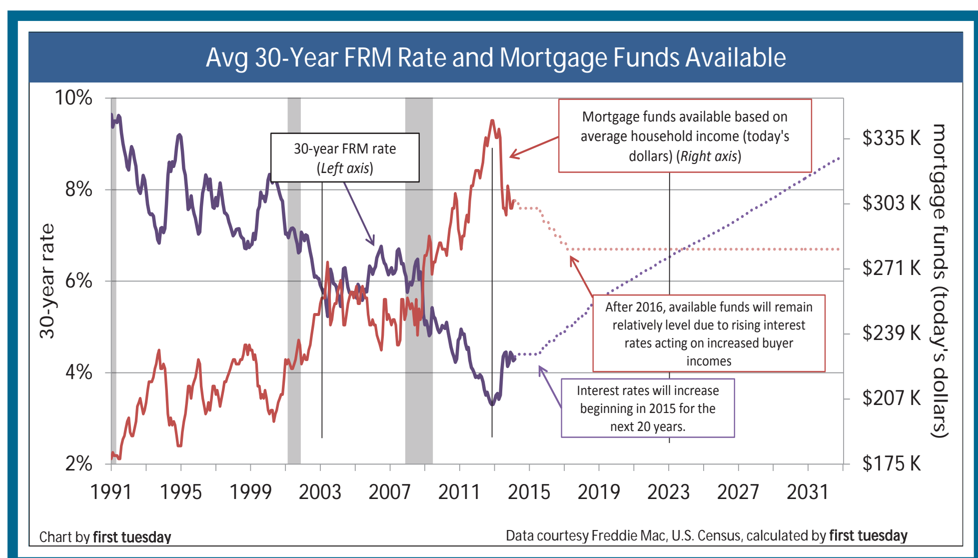
**Note: From August 2010 on, ARM use is a first tuesday calculation based on existing data from DataQuick.*

Higher interest rates hinder ability to borrow

This chart contrasts the average 30-year FRM rate with the corresponding availability of total mortgage funds, stated in today's dollars. It displays how **falling interest rates** for 30 years prior to 2013 constantly increased the mortgage funds available to buyers, driving up prices.

As interest rates rise over the next 20-plus years, this principle will work in reverse. Downward pressure on prices will develop, then go flat into the future in today's dollars. Thus, a reduction in **mortgage funds available** to buyers will usher in the attractiveness of seller financing and ARMs if sellers hold on to their sticky prices.

Looking forward, interest rates will remain at their low level going into 2015. Then, the bond market will drive up 30-year FRM rates, pushing more homebuyers into ARMs to extend their purchasing power and the ability to fund the prices sellers demand.



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