sitelines

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Twin Cities Home-Ownership and Affordability

Matt Mullins

Home-sale records have once again been shattered in 2003 in the Twin Cities Metro Area, establishing records for the 4th straight year. At the end of 2003, the median sales price (the price by which half of the homes sold for more, and half for less) in the Metro Area rose to $199,900, thereby hovering at or above the $200,000 mark for the second-half of 2003. This past year's strong housing market is attributed to low interest rates, a growing population, and a stable economy. So the question remains, "Will 2004 housing prices further soar at record rates in the Metro Area, and how would an increase in interest rates affect affordability?"

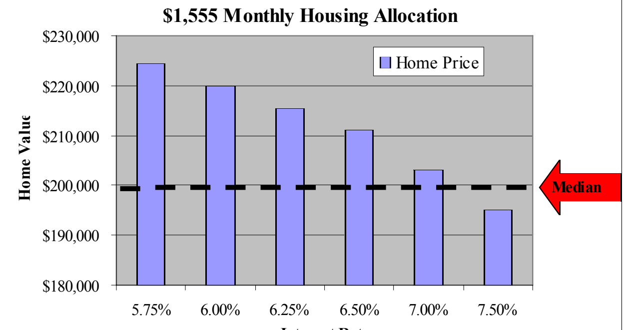
As the median sale price is ever increasing, it is the first-time home-buyers that are most affected by rising housing costs. Today's historically low interest rates are arguably one of the main components that allowed some first-time buyers to qualify for an "affordable" mortgage payment. The Department of Housing and Urban Development (HUD) defines affordable housing costs as up to 30% of a household's adjusted gross income. Housing experts and advocates generally agree that housing is considered "affordable" if households spend less than 30% of their income on housing. For example, a household with an annual income of $62,217 (the median household income in 2003 in the Metro Area) could, according to HUD, afford to pay housing costs of $1,555 per month.

An increase in interest rates, coupled with rising home sale prices could push some buyers out of the market.

Increasing Interest Rates and Rising For-Sale Home Prices

It is estimated that nearly 90% of people who buy a house do so by borrowing money. Thus, when interest rates rise, the monthly mortgage payment must not exceed the maximum amount that a household's budget can afford. Lower interest rates in turn allow homeowners to pay more for their homes (acquire more debt) without significantly raising their monthly mortgage payment. Exhibit A illustrates the change in home price affordability for a median income household based on fluctuating interest rates. The chart assumes a 10% down payment, including principal and interest, property taxes, insurance and private mortgage insurance (i.e., "PMI"). A household with significantly more equity than 10% could afford a higher priced unit, as most repeat homebuyers do. It should be noted many first-time home-buyers have little equity and cash in reserve for a down payment. Therefore, the smaller the down payment, the "less" house one can afford. According to a recent survey conducted by the National Association of Realtors, over 50% of first-time homebuyers have less than a five percent down payment.

Exhibit A
Interest Rate Fluctuation and Home Affordability
$1,555 Monthly Housing Allocation



As illustrated in Exhibits A and B, a slight increase in interest rates (such as one-quarter of a percentage) can significantly affect the amount of home a householder can afford. For example, a median income household can afford a home priced at about $229,000 when locking in a 5.75% interest rate over 30 years. However, when rates increase to 6.0%, that same potential homeowner can afford to purchase a home valued at $220,000, nearly $10,000 less as a result of the increased interest rate. As the table shows, interest rates are one of the determining factors for home affordability. Should interest rates increase significantly, a pool of potential home-owners are priced out of the market. **If interest rates were to rise to 7.5%, a householder earning the median income could no longer afford a median priced home.**

Exhibit B
Twin Cities Median Income Affordability

Total Monthly Payment	$1,555
Interest Rate	Home Price *
5.75%	$224,500
6.00%	$220,000
6.25%	$215,500
6.50%	$211,200
7.00%	$203,000
7.50%	$195,200

* Assuming a 10% down payment. Includes Principal and Interest, Property Taxes, Homeowners Insurance, and PMI Insurance.

When viewed from another perspective, Exhibits C and D on the following page show the monthly payment on a median home priced at $200,000, while adjusting for changes in interest rates. Again, assuming a 30-year fixed loan with a 10% down payment, including taxes, and insurance, a monthly payment of $1,385 would result when locked in at 5.75%. However, the same house purchased at 7.0% would result in a monthly payment of $1,533.

Consequently, an increase in interest rates would require a higher income to afford the median priced home. A householder would need a household income of $55,417 to afford a monthly payment of $1,385, whereas that same home at a 7.0% interest rate would require an income of $63,743, therefore eliminating some prospective buyers from the market.

Record Low Interest Rates

There is little argument that the record-low interest rates in the past few years have stimulated the economy, both locally and nationally. The historically low rates have allowed many renters to become first-time home buyers and in many cases, pay less on a mortgage than what they were paying for rent. It is estimated that approximately 66% of mortgage originations were refinances in 2003, a number that is expected to decrease to about 28% in 2004, as most home-owners have already refinanced with the low interest rates. However, the majority of mortgage applications in recent months have been largely first-time home-buyers, some of whom are cash-strapped and opting for interest-only mortgages and adjustable rate mortgages. Rising home prices have forced many first-time buyers to come up with more cash, take out larger mortgages, or settle for lower-quality homes than they would have otherwise chosen. Although mortgage interest rates are expected to remain stable through

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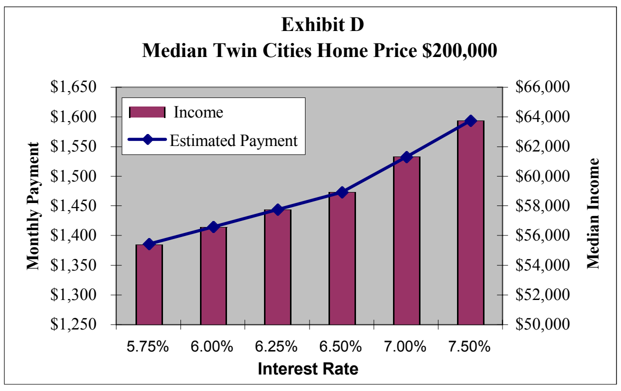

Exhibit C
Twin Cities Median Home Price (2003)

$200,000

Interest Rate	Estimated Payment *	Income
5.75%	$1,385	$55,417
6.00%	$1,414	$56,568
6.25%	$1,443	$57,732
6.50%	$1,473	$58,909
7.00%	$1,533	$61,302
7.50%	$1,594	$63,743

* Assuming a 10% down payment. Includes Principal and Interest, Property Taxes, Homeowners Insurance, and PMI Insurance.

2004, any increase in interest rates will ultimately force some potential home-owners out of the market.

Looking Ahead

Historically, housing markets since World War II have always increased. In fact, there has never been a full year in modern U.S. history when home prices have fallen across the entire U.S. economy. Homeownership today is still viewed as the "American Dream" and most people's single biggest asset. The State of Minnesota historically exhibits one of the highest homeownership rates in the country. According to the 2000 Census, 74.5% of all Minnesotan's owned their homes, second only to West Virginia.

The Metropolitan Council projects a regional population base that is expected to grow by another one million people by 2030. According to Peter Bell, the Metropolitan Council's Chair, the Metro Area must add half a million new housing units to accommodate the area's projected population growth. Due to the scarcity of land in the core cities and first and second-ring suburbs, association-maintained housing such as townhomes and condominiums are expected to be the housing choice for many buyers.

An expanded population base coupled with stable interest rates should produce 2004 home sales similar to 2003, or slightly trailing. Although the median sale price grew by 8% in 2003, median home sale projections for 2004 expect appreciation to be approximately 6% to 7%. The National Association of Realtors projects that the 30-year fixed mortgage will average 6.7% in 2004, still low by historical standards. As a result of low interest rates, new home sales and the mortgage refinancing boom have been the key drivers to boosting the economy, while homeownership continues to be the most solid investment for many American householders. Nonetheless, a rise in interest rates poses the single greatest threat to affordable housing and would push some buyers out of the market.

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Mr. Mullins joined Maxfield Research in January of 2003 as a Research Analyst. He's been in real estate research and consulting for six years, specializing in assessing market demand for proposed and existing real estate projects, conducting feasibility studies and real estate market analysis.

Matt has conducted real estate market research on behalf of a wide variety of clients including the following: housing, retail, tourism, entertainment, gaming, lodging, government and financial institutions.

Matt is a graduate of St. Cloud State University with a degree in Local and Urban Affairs and is a licensed Real Estate Broker in the state of Minnesota. Matt is a member of the Minneapolis Association of Realtors, the Minnesota Association of Realtors, and the National Association of Realtors.

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