Real Estate Market Transformations: Insights and Implications for Canadian Investors and Consumers amid U.S. Interest Rate Adjustments

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Abstract. The world is currently battling the economic costs of the high U.S. dollar interest rate since the cost of living has increased to an unaffordable level for most households, and the real estate market is one of the casualties. Therefore, it is critical to establish the options that real estate investors have that they could consider generating more revenue when the housing market proves unprofitable. The paper aims at assessing how the U.S. dollar interest rate hikes affects the real estate market. The study indicates that the future housing prices are relatively unpredictable; they could either increase significantly, increase by a small margin, or remain the same. In this regard, it is critical to advise real estate investors to venture into other investments where the rise in the U.S. dollar interest rates promises optimal gains, given that the housing market may not be so lucrative.

Keywords: Market uncertainty, Refinancing, Hedge funds.

1. Introduction

1.1. Background

The rising trend in the interest rates of the U.S. dollar wields extensive and multifaceted repercussions on the Canadian real estate sector, delineating a realm of uncertainty and challenge for prospective homeowners and investors. The modifications in the U.S. interest rates can act as a catalyst for alterations in global capital flows, potentially leading to the redirection of investments and causing a fluctuation in borrowing costs on an international scale, including Canada, a closely intertwined economic partner. The alterations in borrowing costs in Canada, coupled with the country's individual policy decisions, profoundly impact the demand and prices within the real estate market, thereby necessitating a nuanced understanding and strategic approach from various stakeholders including buyers, financial institutions, and policymakers.

Furthermore, the responsive strategies and adaptive measures employed by homebuyers, banks, and other related entities play a crucial role in shaping the market dynamics, determining the direction of market trends, and influencing the overall stability of the real estate sector. The analytical exploration of this paper aims to delve deep into this intricate nexus of influences, responses, and market adaptations in the setting of augmented U.S. interest rates. The objective is to elucidate the complex interplays and present informed, strategic recommendations for individuals and entities looking to navigate and possibly capitalize on the evolving challenges and opportunities within the Canadian real estate market.

1.2. Related Research

1.2.1. Prices Increase

According to the study by Endri et al., real estate prices escalate when the interest rate rises. The upward trend is majorly associated with property sellers adjusting unit prices to maintain their initial profit margins. However, in some cases, the increment in sales cost results from other indirect costs. Notedly, property owners may invest in marketing activities like advertising to attract potential buyers as demand declines [1]. The study of LIN & TSAI expresses a similar opinion as Endri et al. Particularly, the author believes that real estate prices will hike following increments in the U.S. dollar interest rate. However, unlike Endri et al., they note that the unit price increments will affect rental

property as well [1,2]. Basically, more prospective homebuyers will settle for rented spaces, thus increasing the demand for rentals as well. Drechsler et al. also echoes the viewpoint held by LIN & TSAI. Notedly, the authors argue that, as rented spaces become more popular, the property increases its value [3]. Therefore, landlords may opt to sell them off at a lucrative value and invest the proceeds in another business. This option is more viable to rental owners whose properties have depreciated in value since it generates a handsome profit. Still, the study of Gomez et al., also emphasize that real estate prices increase once the U.S. dollar interest rate hikes. In his explanation, this happens since lending institutions take advantage of the opportunity to maximize their profit margins. Arguably, banks rely on interest profits to grow. Therefore, they increase interest rates on mortgage loans to ensure that they reap optimal profits. Certainly, real estate prices are always high whenever the U.S dollar interest rate increases [4].

1.2.2. Prices Rise by a Small Margin

The study by Cox and Ludvigson emphasizes that unit prices do not go up by a significant margin following a rise in dollar interest rates. Basically, most lending institutions adjust interest rates to reflect the market value by less than 1%. Further, the author argues that the reason that banks increase interest rates by a small margin is to reduce default rate [5]. Cumming & Hubert also argues along the same line as Cox and Ludvigson, but he gives a different reason to validate his point. Precisely, he notes that the reason unit prices for real estate never change with a significant margin even when dollar interest rates skyrocket is because of customers refinancing their current loans [6]. Basically, this arrangement allows debtors to continue servicing their loans at lower interest rates than the market range. Likewise, Omankhanlen et al. also emphasize that prices for real estate change by a small margin when the U.S. dollar interest rate hikes. Primary, the inquiry gives a varying reason for the unchanged prices. Notedly, they argue that some small-scale lending institutions that are still struggling to expand clientele only raise interest rates by an insignificant margin for fear of losing clientele [7]. Lastly, Whited et al. argue that the increase in real estate prices is too low to be noted, especially in large banks. Basically, they associate the small increment rate with the bank's financial stability. Precisely, major banks have a high clientele, and effecting small changes to the interest rate already generates good revenue. Thus, there is no need to make major adjustments, which would ruin the bank's public image. Indeed, hikes in the U.S. dollar interest rates increases real estate prices by an insignificant margin [8].

1.2.3. Prices Remain the Same

Basten and Mariathasan, however, believe that increments in dollar interest rates do not affect prices at all. In defending their thesis, the scholars explain that competition among lending institutions is too stiff, which prompts banks and other lenders to absorb the costs associated with increased dollar interest rates instead of passing the expense to clients [9]. Likewise, Mehmood and De Luca hold that even if the Fed announces an increase in the dollar interest rate, it will not necessarily lead to a rise in interest rates for all lenders. To support their stance, they emphasize that some lending institutions, especially the well-established ones, have other sources of income, including commissions and service charges [10]. Therefore, they keep their interest rates intact to appeal to interest-sensitive clients. Truly, real estate prices are not dependent on the U.S dollar interest rates.

1.3. Objective

The research attempts to answer three key questions by synthesizing available literature on the Canadian real estate market. The first inquiry is how lending institutions like banks respond to the U.S. dollar interest rate hikes and the motivations behind their reactions. Basically, the research finds out if the institutions increase their rates on mortgages or not, and if so, by what margin. Secondly, the study establishes the impact of the skyrocketed interest rates on consumer purchase decisions, such as whether prospective buyers pursue their homebuying ambitions or if they suspend the plans. Lastly, the inquiry reveals several investment options that prospective homeowners could explore to maximize returns during seasons of high interest rates.

2. Pressure on the Bank of Canada

When the U.S. Federal Reserve raises interest rates, it will undoubtedly have far-reaching consequences globally, especially for countries like Canada, which are closely tied to the U.S. economy. According to Tarver, when the U.S. raises interest rates, Canada could be challenged by capital outflows as investors look for higher-return U.S. assets. This could trigger financial volatility in Canadian markets and could force the Bank of Canada to take measures to stabilize the economy and financial markets. In addition, an interest rate hike in the U.S. would also lead to a decline in global bond prices, so the Canadian bond market would also be affected, and banks and other financial institutions would be under more pressure to raise capital [11].

U.S. interest rate changes may have an equal influence on mortgages in Canada. In order to keep the Canadian dollar competitive, the Bank of Canada has to closely track changes in the exchange rate and could be forced to raise interest rates. consequently, the Bank of Canada is expected to find a balance between preserving domestic economic stability and responding to external financial pressures, as shown in Fig.1. Considering this, a Financial Post poll revealed that more than 70% of respondents believed that another interest rate increase by the Bank of Canada would have a negative effect on their interest in real estate. If the Bank of Canada decides to raise interest rates, it will have significant impacts on domestic lending rates and the real estate market [12].

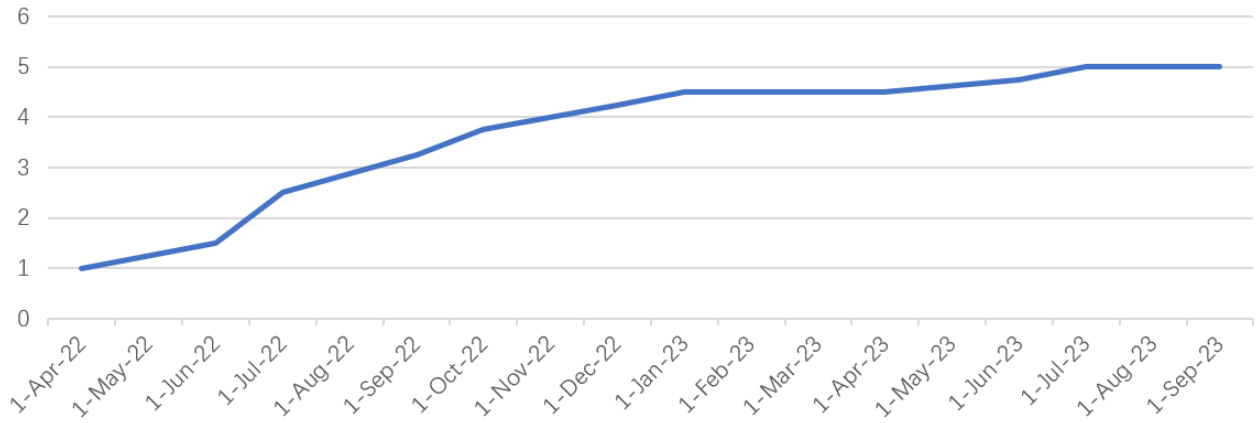


Figure 1. Target Interest Rate of Canada

3. Relationship Between Real Estate Demand and Interest Rate Hikes

3.1. Consumer Confidence and Home Buying Decisions

Interest rate hikes could lower the demand for property, but this is not definite. According to Endri et al., demand in the real estate market will significantly drop following the U.S. dollar interest rate hikes [1]. Precisely, fewer people will willfully take the risk of securing loans to buy homes when the interest rates are skyrocketing. In fact, clients determined to own homes would prefer waiting for the interest rates to go down. However, it is critical to note that not all potential homebuyers will be demotivated from buying property by the rising interest rates. Particularly, some clients would still pursue their home ownership dreams, but only when loan rates do not increase by up to 1%. According to Cox and Ludvigson, a less than 1% hike in interest rate is quite unsubstantial, given that homes are long-term investments. Notedly, a property going for $308,300 would increase monthly loan repayment by $117 if there is a mortgage rate rise of 4%. Certainly, paying $117 more every month would not push many potential buyers away. Indeed, high interest rates pose an extra burden to homebuyers, but not everyone feels the impact [5].

3.2. Opportunities for Homebuyers Due to High Interest Rates

Besides the possibility of the demand for property going down, high interests could be an opportunity for potential homebuyers to explore more competitive mortgage plans. According to

Mehmood and De Luca [10], not all lenders will adjust their interest rates based on the fluctuations of the U.S. dollar. Precisely, some lenders take advantage of the skyrocketing interest rates to expand their clientele by not adjusting their rates at all. Instead, they absorb the associated costs at the expense of reduced profits. For instance, a financial institution could be earning $100 profit from a monthly loan repayment before adjusting the interest rates, and $120 after effecting the changes. However, the lenders may choose to forego the extra $20 monthly profit per mortgage loan, which will eventually decrease the profit margin. However, in the long term, the bank will appeal to a broader clientele. As a result, more potential homebuyers who may speculate future hikes in interest rates could feel inspired to secure homes as soon as possible before mortgage rates become unaffordable. In addition, customers already servicing loans in other banks could decide to sell off their credit to lenders that choose to absorb the expense of high interest rates instead of passing it to their customers. That way, customers enjoy the freedom to explore different mortgage plans instead of sticking with one bank, no matter how expensive it feels. Indeed, some financial institutions that never pass the cost of high interest rates to customers encourage potential homebuyers to seize the opportunity, thus increasing the demand for property.

Apart from increased interest rates inducing more potential homebuyers to buy property, the possibility of the high rates having no impact on the demand for homes is also high. Notably, some purchase decisions are solely influenced by the consumer's confidence in the future of the economy, not the prevailing market conditions. For instance, some classes of consumers who are so positive and have faith in the economy to stabilize believe that their incomes will grow at a rapid pace. Therefore, they do not perceive the high borrowing cost as a deterrent but will go ahead and purchase their desired homes. In contrast, having low confidence in the future stability of the economy compels consumers to shun investment ideas like buying homes. Therefore, even cheap mortgages would not induce the desire to buy a home in a consumer who fears that the economy will move from bad to worse. It is thus critical to argue that the Canadian real estate prices will most likely go up following the U.S. dollar interest rate hikes [3]. However, the cost is not necessarily a factor to consider for some classes of consumers. Therefore, lenders should not hesitate to increase interest rates since their terms will still appeal to a specific market segment. Instead, they should optimize the opportunity, just in case the hikes are short-timed. Assuredly, interest rates do not necessarily translate to affordability in the real estate market.

3.3. Financial resilience and market dynamics when interest rates rise

Further, increased real estate prices in the Canadian market will not reduce the demand for property, depending on the consumer's financial status. As Whited et al. [8] note, being accustomed to low rates for an extended period promotes laxity in that individuals are unable to build their capacities to deal with unexpected rises. However, Gomez et al. [4] argue that some consumers are quite prudent in their spending, and they prioritize saving for future investments. Therefore, individuals who have for long nurtured the dream of purchasing homes will still pursue their ambitions irrespective of the high interest rates. Hence, it is arguable that changes in interest rates never deter the financially stable consumers from becoming homeowners. It is thus commendable for lending institutions to implement new interest tariffs without fear of losing clients. Therefore, demand for housing remains the same irrespective of the dollar interest rates.

Lastly, high interest rates could reduce property prices in the real estate market. As Omankhanlen et al. [7] elaborate, prospective buyers could shelve the idea of buying a home following a rise in interest rates. They make these decisions in the hope that the interest rates will drop in the future, after which they will revisit the idea. Ultimately, too many prospective buyers suspending their purchase plans increases the supply of dwellings. In turn, oversupply compels property sellers to reduce the selling price as they compete for the attention of the few buyers in the market. As a result, first-time buyers and individuals with a comfortable cash buffer could seize the opportunity to purchase their dream homes. In the long-term, the prevailing housing affordability crisis would be solved. On the same note, high interest rates would significantly increase rental fees. Basically,

prospective homebuyers who suspend their home buying projects would look into renting. As a result, the number of renters would significantly surge, prompting landlords to increase rent. Undeniably, rises in interest rates reduces the cost of buying property but increases rental fees.

4. Recommendations

4.1. Banking and Brokerage Investments in High Interest Environments

Prospective property buyers should explore other options like investing in banks and brokerage firms when interest rates hike. As Mehmood and De Luca emphasize, interest is the core source of income for banks and brokerage firms [10]. Therefore, a hike in interest rates is an opportunity for these institutions to increase their revenue margins. However, credit is not as readily available during seasons of high interest rates, which prompts banks and brokerage firms to charge customers more when lending money. In the long term, the institutions generate higher interest income and operating profit margins. In contrast, borrowers have more cash at hand during seasons of low interest rates. Therefore, their spending patterns and borrowing trends are equally higher. Ultimately, banks and other lending institutions make money from the interest they earn in larger volumes. Furthermore, even a drop in the rates rarely affects the profitability of the bank since the facilities still earn fees, commissions, and service charges from their clients for the services rendered. Certainly, channeling savings towards bank shares is a viable option instead of buying property when interest rates are high.

Another viable option for prospective property buyers to explore entails investing in cash-rich companies, especially stocks that pay cash dividends [13]. Basically, cash-rich companies appreciate high interest rates since it is an opportunity to earn more from their cash reserves. However, it is instrumental for investors to consider firms with low debt-to-equity ratios or ones with large amounts of cash. In addition, companies worth exploring include the large, mature businesses that hoard cash, such as Apple Inc. On the same note, it is risky to invest in smaller and less mature companies that hoard cash. Notably, risk-averse investors should understand that these businesses should be reinvesting the cash in their growth. Without doubt, investing in cash-rich companies guarantees prospective homebuyers promising returns during times of high interest rates.

4.2. Timing Property Purchases and Speculation

It is equally commendable for investors looking forward to investing in real estate to time their purchase time. Particularly, they should target buying when interest rates are low. According to Cumming & Hubert, there are numerous monetary benefits associated with refinance during a period of high interest [6]. Notedly, the purchases could result in substantial savings in financing charges and overall long-term costs. In addition, the investors could buy the property for speculation purposes. This approach entails buying property to resell once interest rates hike. Ideally, this tactic generates significant revenue for the investor, given that the selling price will factor into the current interest rates. However, it would be critical for investors to keep monitoring fluctuations in interest rates to resell the property when the projected profits are optimal. On the same note, the investor must track the Federal Reserve's actions and economic conditions to seize the most promising business moment. Indeed, timed purchases are much more profitable, provided the investor is skilled to monitor economic trends so as not to miss out on the most profitable business seasons.

4.3. Refinancing Strategies in Rising Interest Rate Scenarios

Investment advisors further recommend refinancing existing debt at a fixed rate when interest rates rise. Basically, the inflation of the U.S. dollar interest rates comes at a time when most Canadians are paying mortgages. However, they could still overcome the associated drawbacks by refinancing their current debts. The option of refinancing an existing debt at a fixed rate works best for variable-rate debt, including adjustable-rate mortgages (ARMs). The tactic helps individuals to lock in a lower interest rate, which would save them money on interest payments over the loan life. On the same note, there is stability and predictability in monthly payments associated with fixed-rate loans, which helps

in budgeting [5]. However, the investor should analyze closing costs and origination fees to ensure that refinancing is indeed a cost-effective option. Similarly, investors should consider their overall financial situations to ensure that the refinancing option aligns with their long-term financial goals. Certainly, the rising interest rates should not scare real estate investors who can gain from refinancing.

4.4. Diversifying with Safe Assets in Uncertain Times

Investors looking forward to invest in home ownership should also prioritize rental properties as another option for overcoming the economic costs of increased interest rates. Basically, rentals are a profit-maximization strategy during times of rising interest rates. Generally, obtaining mortgages is quite difficult for prospective homebuyers when interest rates are high. As a result, the demand for rental properties is exceedingly high during such times [2]. On the same note, rental rates go high as well, thus increasing higher cash flows for property owners. Furthermore, property value increases, just in case the owner wishes to sell off the rentals in the future. Likewise, it is commendable for the investors to consider fixed-rate loans since mortgage payment remains the same even when interest rates start declining after obtaining credit due to the associated benefits that outweigh the risks. Notably, the loanee enjoys more predictability and stability in mortgage payment, which could significantly improve their budgeting and cash flow management. Additionally, the major perceived risk of refinancing is the penalty applied for breaking the fixed-rate contract. Undeniably, investing in rental properties instead of private homes is a more lucrative business when interest rates escalate.

On the other hand, for conservative investors, especially those with lower risk tolerance, diversifying their portfolio with safe assets like gold and precious metals is often advised in times of economic instability or market volatility. According to Baur and Lucey, in the past, these assets have proven to be flexible, often retaining or rising in value while other investment vehicles decline in response to recession or growing market uncertainty. They also mentioned that gold can operate as a hedge funds against stock market swings and offer significant protection in extreme market conditions. Additionally, investing in precious metals can provide investors with liquidity, enabling them to easily turn their assets into cash when necessary [14]. When there is greater economic uncertainty or market stress, this liquidity and the steadiness that is frequently linked to precious metals could be especially helpful to investors.

5. Conclusion

Overall, there are three major outcomes expected in the real estate market when the U.S. dollar interest rate hikes. First, the prices of property could escalate to unaffordable levels, which would significantly lower the demand. Second, landing institutions could adjust mortgage loans by such a small margin that many customers would not feel the burden of the new premiums. Therefore, the demand for housing would remain relatively the same. Third, the prices of property would not change when banks decide to absorb the cost of hiked interest rates. Hence, there would be no notable changes in the demand for housing. However, customers react differently to hikes in the U.S. dollar interest rate. For instance, consider homeownership to be a necessity while others would give up buying a home because of high prices or inflations. Nevertheless, there are more profitable alternatives that customers could explore, investing in stocks, refinancing a loan to maintain cash flow or investing in precious metals instead of focusing on real estate investment.

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