The Home Buyer's Dilemma: Buy Now Or Wait?

If you are considering buying a home you are probably wondering, "Should I buy now or wait?" This could be a difficult decision to make and may depend on many factors both economic and personal. Here I am only interested in analyzing numeric information for the purpose of creating a hypothetical range for the optimum point of entry.

So where might be the optimum point of entry? I think most of us would agree that (assuming we were in the market to buy a home today) we would buy a property right now if we could buy it for what it would have sold for 10 years ago. Hence we can assume the optimum point of entry in purchasing a property in the current real estate market would be between what it sold for 10 years ago and what it would have sold for at the peak of the market.

Let us create a numeric example. A house with a value of $250,000 10 years ago increased to $500,000 at the peak of the market. Since the peak of the market the house has declined 10%. $500,000 would become the hypothetical ceiling price for the property and $250,000 to become the hypothetical floor price for the property.

To further narrow the hypothetical range we should examine the cost of construction. Assume that the house would have cost $150,000 to build 10 years ago and now would cost $300,000 to build. Further assume that the land value 10 years ago would have been the market value of $250,000 less the cost to build at that time of $150,000, or $100,000.

If you could buy a property for the cost to build today plus the estimated land value of 10 years ago, would you buy it? I think most people would answer "yes"; hence we have a new hypothetical floor price of $400,000 (the $300,000 cost to build today plus the $100,000 estimated land value of 10 years ago.)

Now –

Price at Peak $500,000
Today’s Price $450,000
Hypothetical Floor $400,000

Now we are $50,000 below the high and $50,000 above our hypothetical floor price.

Can we assume that the value of the property would never fall below our hypothetical floor price? The answer is "no". In fact during the early 1990’s there where many instances where housing values dropped below their replacement cost (cost to build). The cost to build a home does not create an absolute floor price for any home’s falling market value but hypothetically may create some resistance at that level over the long term.

Now let us analyze interest rates and their potential effect on housing. Assume that 30 year fixed mortgage rates were 8.75% 10 years ago, and now are 5.75%. Assume that the annual real estate taxes of the property have increased from $5,000 to $10,000 today and that any buyer intending to acquire the property would place a down payment of 20% and borrow with a 30 year fixed mortgage.

Now 10 Years Ago Increase%

Price $450,000 $250,000 80.00%
Cost To Build $300,000 $150,000 100.00%
Land Value $150,000 $100,000 50.00%
Mortgage Amount $360,000 $200,000 80.00%
Mortgage Rate 5.75% 8.75%

Extrapolating the above:

Now 10 Years Ago Increase%

Mortgage Payment $2,101 $1,573 33.56%
Monthly Taxes $834 $417 100.00%
Total Monthly Payment $2,935 $1,990 47.49%

Declining mortgage rates create economic value for the buyer/borrower. If 30 year mortgage rates rise from 5.75% back to 8.75%, the value of a $360,000 (5.75% fixed rate) loan issued today would fall from $360,000 to approximately $267,047 (using the NPV method). This translates into a gain/loss of $92,953 assuming the loan is held until maturity.

Observe that the total monthly payment has increased by 47.49%. This is an interesting piece of information because it allows us to observe how much the proposed monthly payment has increased in relation to the price of the home after taking into effect the decline in 30 year mortgage rates and any increase in real estate taxes.

As a buyer what do you do? Much of this decision making will depend on individual circumstances. A buyer that intends to live in the home for only a short period of time may be advised to wait out the current uncertainty in the market. A buyer that intends to live in the home for ten years or more may be inclined to lock up the current circumstances. It all depends on your personal tolerance for risk, your personal needs, and your ability to sustain losses. It would be difficult to time the bottom of the market, but at the same time no one could afford to buy a house today and sell it in a year if prices continue to fall.

Please note this article was written for information purposes only and should not be relied on to make material financial decisions. Speak to your lawyer, financial advisor and your tax specialist for professional advice in purchasing a home.

About the Author

Calvin Calbuild is an analyst of the Business Real Estate Calculators, and Mortgage Calculators, who has combine 20 years experience in Coding in Visual Basic, Yield Curve Construction, Financial Statement Preparation, Business Plan Development, Complex Derivative Valuation and Risk Management.