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Ramifications of interest rate rise: Volatility speaks volumes

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The Fed has done it again. After a few comments by some regional Federal Bank chiefs, indicating that an interest rate rise is likely in September, the stock market took a nosedive. To be fair, China's apparent economic unwinding was also substantially to blame. Not to mention fewer traders working, instead on vacation, and thus low trading volume. Nonetheless, the stock market showed once again that an inevitable rate rise by the Federal Reserve Bank has not been "baked in" as TV pundits are quick to say. When it happens, will there be a shock to the system?

In my last article, I stated all the reasons why there should be a rate hike. My conclusion, however, was before the recent 15 - 20% dive, which left the Dow Jones negative for the year to date. As soon as that happened, the Fed chiefs were also quick to flip-flop that maybe they had been too aggressive, that maybe the rate hike would not occur in September. Thus, even the discussion of such, causes volatility in the marketplace, and fear of ramifications. Given this, I chose to write about what might happen, both good and bad.

Let's start with the good. The tiny rate hike being discussed at .25% will be good because it is the start of the end of market manipulation. It will get us over the hump of constant worry about rate hikes, and although there may be some quick pain inflicted, there will be more predictability. On the other hand, the down side is blatant. There is no question that lower interest rates have and will spur real estate purchasing activity. Thus, it stands to reason that an increase in rates will have the opposite effect, by reducing demand due to higher costs of money. As important, some buyers will have lost their down payments, with a stock market decline. While not everybody is in the stock market, when it is rising, people feel wealthier and will buy more, and when it is lowering, buyers pull back quickly. With lower demand, higher costs of borrowing, higher cap rates, less income after debt service, real estate values will inevitably decrease. A good case in point is the Real Estate Investment Trust market which has, depending on the sector, returned 10-25% return over the last seven years. When this increase is charted against decreased interest rates, it shows an inverse relationship.

Some would argue that there are other potential offsets, other than interest rate increases or decreases, which more dramatically affect the marketplace. The main one is that an interest rate rise is typically reflecting an improvement in the economy, which means lower unemployment, higher job growth, higher income, thus offsetting a potential decrease in real estate values. People can afford more, and thus they are more able to take out a more expensive mortgage. Moreover, small interest rate increases are not deal breakers. There is not a direct correlation in the short term between interest rate increases and the real estate market. In fact, some say that a slight rise will cause a short term increased demand for purchasing real estate; people think that rates will continue to rise, potentially keeping them out of the market in the future, and so they act.

On balance, I believe the evidence mostly shows real estate markets will decline with rate increases. Certainly, as evidenced by recent volatility, at best rate increases cause ups and downs in the market, and low confidence. When we graph this over the next ten years, I am sure we will show stabilization and a smoother curve over the current peaks and troughs. But you need to have a long term horizon in order to benefit from a longer term stabilization. In the meantime, don't buy in a peak and get caught in a trough.

Daniel Calano, CRE, is the managing partner and principal of Prospectus, LLC, Cambridge, Mass.