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Interest rate, cap rate, inflation: A witches brew? - by Daniel Calano

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Over the last several years, since the 2008 Great Recession and earlier, I have written individual articles about interest rates, whether they would increase, whether it would affect real estate values, investment, and cap rates. I worried, as did many. Some were certain rates would increase. Cap rates would follow. Inflation would ensue, or demand would decrease.

Basically, this hasn't happened, somewhat to our collective analyst/writer embarrassment, but all really good news. Bank borrowing rates have ranged between 3.5% and as low as 2%. Cap rates have grown a little, but found to not correlate necessarily with interest rates. The economy has grown until COVID, but appears to be coming back strongly. None of these modest fluctuations has substantially impacted real estate investment. In fact, the markets as we know have been on fire.

But this time, is it different? There are currently some same and other new issues afoot, related to rates, but including COVID costs, huge increases in U.S. debt, and potential inflation. They are all related and seemingly marching together. Is it a witches brew, celestial concoction? I needed to investigate whether the proverbial sum is greater than the parts. Not easy. Wish me luck!

First, let's start with rates in an inflationary environment. As you know, the Federal Reserve has direct control over short-term "over-night" rates, but not the longer 10 year bond rates, for example, which mostly correlate with residential and commercial borrowing rates. Fed Chairman Powell has publically stated that Federal Reserve policy would be to not raise rates, let inflation happen if necessary, in order to keep the economy running hot. Thus, any actions the Fed would take would be reactive rather than preemptive. But, it is unclear whether reaction could control the inflation, once out of the box.

If there is inflation, how does it affect the bond market, and thus residential and commercial borrowing rates? If it affects them detrimentally, in other words increasing cost, how great would the impact be? Would inflation ultimately lead to a weakened and less reliable dollar? Finally, should we worry about it, or will a strong economy create strong demand so that the cost of money, albeit increasing, is not of concern.

The answers are yes, maybe, and probably not. Crystal clear yet? The Fed actually can indirectly “manage” longer term rates. For example, the Fed can purchase our own U.S. Treasuries, thus absorbing supply, increasing price and lowering required rates of return, in the typical inverse relation. The Fed has already committed to buying over $200 billion of mortgage which could keep long-term rates somewhat lower.

But higher borrowing rates are not the only impact of inflation. The cost of goods will increase, causing real estate to be too expensive to build, when compared to people’s ability or desire to buy. Cost of goods like lumber and steel has already risen, and labor cost is growing. So, inflation has some detrimental impact in any case, but we have prospered despite it many times before this.

How do annual deficits and the growing National debt fit in? According to the American Banker, a national publication watching debt, national debt has grown enormously since the great recession. The national debt clock, a mechanical metric ironically created by a real estate tycoon named Seymour Durst in 1989, shows this shocking evidence. When Durst died in 1995, national debt was four trillion dollars. Currently, the clock reads over $28 trillion. Many feel that debt growth is not significant, so long as gross domestic product, GDP, keeps pace with debt in a Debt/GDP ratio that is lower than one. Unfortunately, the ratio is now about 1.1 with GDP falling behind. If the ratio continues to worsen, it suggests economic troubles ahead. The good news is that current estimates of post-COVID GDP have moved from 4% to a recent Goldman Sachs estimate of 9%.

Clearly there are no easy answers, or even understandable and consistent analyses. On the one hand, with national debt growing quickly, unforeseen COVID costs, some inflation, all with interest rates being kept low - artificially low, there are legitimate areas of concern. On the other hand, the real estate market has done well in part because of these federal interventions. My take-away is that we have troublesome issues to watch, but they are less significant than we have endured before. Rates have been much higher, inflation much more prevalent, collective confidence much lower, and we have managed our way through. With strong growth, we can endure more than the current risks appear to be.

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