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Update on causes of inflation - by Robert Concannon

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What is inflation? What does it mean to real estate investors? When does it start? When does it end? How is it measured?

Unless you've been living under a rock, benefiting from a trust fund, or are simply oblivious to day to day life…it seems that almost everything is more expensive in the post COVID-19 world. The essence of inflation tends to be tied to the prices that we pay for things (food, transportation, housing etc.). Over time, most prices tend to increase, but generally we don't notice because it happens slowly over extended periods. An example is the daily increase in fuel prices that don't make much of a difference for most commuters' weekly transportation costs. The relationship for the prices for goods and services and the changes in these prices over time are tracked through a metric we know as inflation.

Here's a simple definition of inflation…it's when things cost more than they used to. This isn't necessarily a bad thing, but it can have a very real impact on your money/purchasing power. No matter how you look at inflation, it has very real impact(s) on what you do with your money. This translates to how we spend it, save it, or invest it. Each presents very different implications for an investor's future.

There are many different causes for inflation...but most center around increased costs (supply chain challenges) and increases in demand (consumers willing to pay more for a limited supply of goods and services). Both impact most sectors of the real estate markets with varying underlying factors (supply chain, tariffs, shipping delays, material shortages) contributing each.

So what does this mean to real estate investors? How does this affect the many different classes of real estate and ultimately how does it impact buyer/sellers? Here are a few things that are reflective of an inflationary environment.

• Inflation generally leads to higher asset (real estate) prices – As this price of things increases with inflation, so too does real estate. Generally speaking, when inflation increases then housing and other real estate asset prices follow suit.

• Inflation causes building (soft and hard) costs to rise – Because all things increase in price with inflation, the cost of materials used in construction will also rise. Inflation increases wages, machinery costs, and building materials. It also puts increased stress on developers and investors as cost-overruns become much more possible. Sometimes, the perception of inflation delays project timing and results in further cost increases with sub-contractors and general contractors attempting to hedge anticipated increases for specific projects.

• Residential housing outperforms other asset classes during inflationary periods – This is evident in almost every major housing market in the country with double digit appreciation being reported since the outbreak of COVID-19. This has a two-fold impact on most homeowners as the market value of their home increases so do the alternative costs to replace it (buying a new home) and generally so do related ownership (occupancy) costs. Inflation also makes construction more expensive, which benefits property owners because they can expect less competition from new buildings.”

• Inflation reduces relative value of outstanding debt by decreasing its cost as interest rates rise. This is portrayed by the impact of rising interest rates on almost any market value of a fixed rate financial instrument. Bankers call this interest rate risk. As rates rise, the relative value of debt goes down. It’s actually an inverse risk for them (bankers) because their assets (loans) do no reprice as quicky as their costs of funds (deposits/checking accounts).

• Real estate serves as a hedge in an inflationary period. This is attributed to the impact of rising rents in most property types, increased appreciation/market values (rising construction costs and higher demand) and relatively lower debt values. It’s almost like a “perfect storm” of positive factors that leads to unparalleled growth in market values.

• Inflation generally leads to higher interest rates. As inflation increases, most central banks (US – The Federal Reserve Bank) increases interest rates to slow spending and increase savings.

Without a doubt, it appears that many of the above forces are at work, locally and nationally. In northern New England, these forces are all in place with unprecedented levels of appreciation in all sectors of the residential home markets. Most appraisers/brokers believe that the current trend will continue into 2022 and possibly longer. Until the availability of housing improves or demand subsides, there is no reason(s) to expect it to change.

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